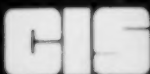


NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.



Congressional Information Service,
Washington, D.C.

SOCIAL SECURITY TRUST FUND RESERVES

HEARING BEFORE THE SUBCOMMITTEE ON SOCIAL SECURITY OF THE COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

MAY 10, 1988

Serial 100-58

Printed for the use of the Committee on Ways and Means



U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1988

87-668

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

H781-11

COMMITTEE ON WAYS AND MEANS

DAN ROSTENKOWSKI, Illinois, *Chairman*

SAM M. GIBBONS, Florida	JOHN J. DUNCAN, Tennessee
J.J. PICKLE, Texas	BILL ARCHER, Texas
CHARLES B. RANGEL, New York	GUY VANDER JAGT, Michigan
FORTNEY PETE STARK, California	PHILIP M. CRANE, Illinois
ANDY JACOBS, JR., Indiana	BILL FRENZEL, Minnesota
HAROLD FORD, Tennessee	DICK SCHULZE, Pennsylvania
ED JENKINS, Georgia	BILL GRADISON, Ohio
RICHARD A. GEPHARDT, Missouri	WILLIAM M. THOMAS, California
THOMAS J. DOWNEY, New York	RAYMOND J. McGRATH, New York
FRANK J. GUARINI, New Jersey	HAL DAUB, Nebraska
MARTY RUSSO, Illinois	JUDD GREGG, New Hampshire
DON J. PEASE, Ohio	HANK BROWN, Colorado
ROBERT T. MATSUI, California	ROD CHANDLER, Washington
BERYL ANTHONY, JR., Arkansas	
RONNIE G. FLIPPO, Alabama	
BYRON L. DORGAN, North Dakota	
BARBARA B. KENNELLY, Connecticut	
BRIAN J. DONNELLY, Massachusetts	
WILLIAM J. COYNE, Pennsylvania	
MICHAEL A. ANDREWS, Texas	
SANDER M. LEVIN, Michigan	
JIM MOODY, Wisconsin	

ROBERT J. LEONARD, *Chief Counsel*
M. KENNETH BOWLER, *Staff Director*
A.L. SINGLETON, *Minority Chief of Staff*

SUBCOMMITTEE ON SOCIAL SECURITY

ANDY JACOBS, JR., Indiana, *Chairman*

RICHARD A. GEPHARDT, Missouri	BILL ARCHER, Texas
SAM M. GIBBONS, Florida	PHILIP M. CRANE, Illinois
SANDER M. LEVIN, Michigan	HAL DAUB, Nebraska
JIM MOODY, Wisconsin	

CONTENTS

Press release of Tuesday, May 3, 1988, announcing the hearing	Page 2
---	-----------

WITNESSES

Congressional Research Service, Library of Congress, P. Royal Shipp, Senior Specialist, Social Legislation.....	8
Congressional Budget Office, Robert W. Hartman, Acting Deputy Director	18

Robert J. Myers, former Chief Actuary, Social Security Administration.....	31
Alicia H. Munnell, Federal Reserve Bank of Boston	40
Henry J. Aaron, the Brookings Institution.....	48
John L. Palmer, the Urban Institute	56

APPENDIX

Summary of 1988 Trustees' Report	73
Questions and responses of some of the witnesses	75

SUBMISSIONS FOR THE RECORD

American Academy of Actuaries, Committee on Social Insurance, Robert J. Myers, et al., statement	97
Hon. Rod Chandler, a Representative in Congress from the State of Washington, statement.....	6
Hon. Philip M. Crane, a Representative in Congress from the State of Illinois, statement.....	98
Hon. Byron L. Dorgan, a Representative in Congress from the State of North Dakota, statement.....	99
Lafayette G. Eads, NCPSSM Grassroots Division, Bloomington, Ind., statement.....	100
Edwin R. Miner, Committee To Correct Inequities in Social Security and Medicare, Inc., Council Bluffs, Iowa, statement.....	101

SOCIAL SECURITY TRUST FUND RESERVES

TUESDAY, MAY 10, 1988

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SOCIAL SECURITY,
Washington, DC.

The subcommittee met, pursuant to call, at 1 p.m., in room B-318, Rayburn House Office Building, Hon. Andy Jacobs, Jr. (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

(1)

FOR IMMEDIATE RELEASE
TUESDAY, MAY 3, 1988

SUBCOMMITTEE ON SOCIAL SECURITY #9
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-9263

ANDY JACOBS, JR. (D., IND.),
CHAIRMAN, SUBCOMMITTEE ON SOCIAL SECURITY,
COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES
ANNOUNCES A HEARING ON
THE SOCIAL SECURITY TRUST FUND RESERVES
ON TUESDAY, MAY 10, 1988, AT 1:00 P.M.,
IN ROOM B-318 RAYBURN HOUSE OFFICE BUILDING

Andy Jacobs, Jr. (D., Ind.), Chairman of the Subcommittee on Social Security, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a hearing on the social security trust fund reserves and the financing of retirement benefits for the "baby-boom" generation.

Much attention has been focused recently on the buildup in the social security trust funds. In fiscal year 1988, income to the Old Age, Survivors and Disability Insurance (OASDI) Trust Funds will exceed outgo by an estimated \$37 billion. Reserves will have increased to more than \$100 billion by the end of this fiscal year and will reach more than one trillion dollars by the turn of the century. Trust fund reserves will reach their peak early in the century, will begin to decline as the "baby-boom" retires, and will be exhausted by mid-century.

The Social Security Amendments of 1983 were especially designed to create a reserve that would assure the payment of benefits well into the next century. The amendments represented a carefully crafted compromise which reduced some benefits for both current and future retirees and increased payroll taxes on workers. Under the 1983 amendments, the payroll tax was increased in 1988 and will increase again in 1990.

The 1983 amendments also removed the social security trust funds from the unified budget. However, the annual surpluses in the funds continue to be counted for purposes of meeting the Gramm-Rudman-Hollings budget targets.

Some experts have suggested that the payroll tax increases should be reduced so that the system's income and outgo are more evenly balanced. Others believe the buildup in the reserve is sound policy and should not be altered. Some experts have raised both economic and political questions about the relationship of the buildup in the reserves to the deficit in the general fund. Still others are concerned about the system's ability to pay for the promises which will come due when the "baby-boom" generation retires.

The Subcommittee will receive testimony from several expert witnesses. P. Royal Shipp, Senior Specialist, Social Legislation, Congressional Research Service and Robert W. Hartman, Acting Deputy Director, Congressional Budget Office will present the report prepared for the Committee on Ways and Means entitled "Retirement Income for an Aging Population." The Subcommittee will then hear from a panel composed of Alicia Munnell, Senior Vice-President and Director of Research, Federal Reserve Bank of Boston; Robert J. Myers, former Chief Actuary, Social Security Administration; John Palmer, Senior Fellow, The Urban Institute; and Henry J. Aaron, Senior Fellow, Economic Studies, The Brookings Institution.

(MORE)

Other persons or organizations interested in offering their views to the Subcommittee may submit written comments for inclusion in the printed record of the hearing.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons submitting written comments for the printed record of the hearing should submit six (6) copies by the close of business, Tuesday, May 24, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing a written statement for the record of the printed hearing wish to have their statements distributed to the press and the interested public at the hearing, they may provide 75 additional copies for this purpose to the Subcommittee office, room B-316 Rayburn House Office Building, during the course of the public hearing.

FORMATTING REQUIREMENTS:

COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman JACOBS. The purpose of the hearing today is to consider the latest report of the Social Security Trustees and implications of the reserves. Depending on whom you talk to, it is perfectly good, perfectly awful or imperfect.

Our first witnesses represent the Congressional Research Service, Mr. Shipp, and the Congressional Budget Office, Mr. Hartman. If you would come forward and present your testimony, we will accept it gleefully, but pending that, we will call on the cochairman, Mr. Archer.

Mr. ARCHER. Thank you.

I want to apologize to the committee. I have a conflict because the Trade Subcommittee is marking up the Canadian Free Trade Agreement, and I feel it is important I be there to cast votes on that measure. But I did want to thank you for scheduling this hearing on the trust fund reserves.

I have a deep concern about the long-term health of these programs and I know, Mr. Chairman that you are aware of that concern. Although the significant buildup of reserves is years away, your hearing is a timely one.

I believe we should be thinking about the interaction of these reserves and other Federal entities before we receive any recommendations of the National Economic Commission early next Congress.

I must admit—after the financial panic surrounding much of the Social Security legislation since 1977—it is almost a relief to contemplate the other side of the coin, potentially enormous reserves in the 21st century.

However, the impact of reserves may be even more challenging for us, because it transcends the issues of the Social Security entitlements and taxes. A combined OASDI trust fund which exceeds 25 percent of the GNP must interact with the Federal deficit.

Additionally, reserves of that magnitude may require us to reconsider trust fund investment policies, as well as to consider the impact of interest rates on the trust funds, or indeed of the trust funds on interest rates. I am sure today's witnesses will educate us about these, and other related issues.

Mr. Chairman, the primary reason we are here today is to face the issues caused by the demographic changes in this century. The work force is steadily declining and the number of retirees growing. I cannot forgo this opportunity to urge the consideration of my bill H.R. 3794, which would phase out the retirement earnings test for workers who have reached the normal retirement age.

In the long term, as you know, H.R. 3794 is a wash, and may actually produce slight savings to the Social Security system. Looking at the broader picture, the national economy, I am absolutely convinced we should encourage senior citizens who have the health and desire to continue working to contribute to our economic good health.

I would hope that whatever legislation we might develop in anticipation of these demographic changes would remove this last vestige of age discrimination in the employment of older Americans.

I look forward to hearing from today's witnesses, and in my case, the opportunity to read the testimony because I will have to be leaving shortly.

I would ask permission, if I might, to submit questions in writing.

[See the appendix for Mr. Archer's questions and their responses.]

Chairman JACOBS. Without objection, it is so ordered pending the cooperation of the witnesses.

Mr. CHANDLER. I would like to thank you at this point for allowing me to sit in on this hearing and with the consent of my colleagues, I would submit a statement.

Chairman JACOBS. Without objection, it will be accepted, Mr. Chandler.

[The statement of Mr. Chandler follows:]

STATEMENT BY
HONORABLE ROD CHANDLER
BEFORE THE SUBCOMMITTEE ON SOCIAL SECURITY

Tuesday, May 10, 1988

Mr. Chairman, I would like to commend you for calling this hearing on Social Security trust fund reserves and the financing of retirement benefits for the "baby-boom" generation. This is an important issue that deserves the immediate attention of Congress.

I have been concerned for some time about the mounting federal budget deficit and the burden it will place on future generations. Last fall, when congressional leaders and the administration were finalizing their relatively modest cuts in the budget, I argued that we not only needed to reduce the budget deficit, but we needed to provide a realistic accounting of its size. In saying this, I am referring to the current practice of including the Social Security trust fund balance in calculating the budget deficit. This accounting gimmick reduces the deficit to the tune of \$113 billion in 1989 and \$374 billion over the next three years.

What's more, the trust fund balance is being "invested" in government securities. By 1998, the Social Security annual cash surplus will exceed the federal budget deficit. In fact, it is conceivable that by the year 2015, the entire federal debt could be held by the Social Security trust fund. Think of the impact that such a development would have on private investment options.

And think of the impact that it has on the security of the Social Security system itself. The American people are being told that the Social Security payroll tax they're paying now will be used to pay for Social Security benefits in the next century. In reality, this money is being spent today with IOUs issued for the future. When it comes time to provide these benefits 30 or 40 years from now, the leadership of this country will have to tell the American people: "Either you don't get your Social Security because we spent that money 40 years ago or we must now raise taxes to exorbitant rates to make up the difference."

And the problem doesn't end there. The baby-boom generation will begin retiring in the next 20 years. As a result, fewer people will be working to support more Social Security beneficiaries. According to the Census Bureau's intermediate projections, the number of people age 65 and over will increase from 31.7 million in 1990 to 39.2 million when the first of the baby boom population becomes 65 in 2010. The number of retirees will climb to 64.6 million when the last baby boomers retire.

The 1987 Social Security trustees report indicates that beginning around the year 2015, Social Security payroll tax receipts will fall short of expenditures and stay there indefinitely. At that time, the federal government will need to begin repaying the funds it borrowed over the past 30-40 years. It will be necessary to produce a federal budget surplus, then repay trust fund balances on top of that. Because the number of workers to retirees (the dependency ratio) is expected to be no more than two-to-one by that time, future working Americans stand to be overwhelmed by this burden.

Mr. Chairman, the philosophy of building a trust fund balance is a sound one. However, its current application, with the trust fund balance being immediately consumed is a mistake. I'm not prepared to say that we should limit the payroll tax rather than building a balance, and I'm not prepared to say that we should invest the balance in the private sector. But I am convinced that business-as-usual will bankrupt the system. Current retirees are not at risk -- not yet. But people in their mid-40s and younger have every right to be skeptical of the promise that they will receive all -- or even part -- of the Social Security benefit they have been promised.

Statement before the Social Security Subcommittee
May 10, 1988
Page 2

I am now exploring the feasibility of using Social Security Trust Fund receipts to finance the capital expenditures of the federal budget. The idea is to establish a separate budget for the capital investments of the federal government. For instance, when we buy an aircraft carrier, we would project its useful life. If its useful life were 30 years, we would borrow the money from the trust fund to buy the carrier, and pay it back over a 30-year period.

It might also be possible to invest Social Security Trust Fund assets in state and local government public works projects. We could use the funds to build water supplies, treat sewage, dispose of solid waste, build roads and airports and revitalize cities. In so doing, we would be using the trust fund to make long-term investments, with a fixed schedule for repayment, rather than simply spending the money for general government expenditures.

Finally, when those of us in our 40s retire in the second decade of the next century, we may well face the tragedy of a broken promise. It may be impossible for us to receive the Social Security benefits we are due. We may pay into the system all our lives and receive little or nothing in return. The irony is that it will be a promise to ourselves that has been broken. And we will have no one but ourselves to blame.

It is not too late to act. We owe it to ourselves and our children to do so.

**STATEMENT OF P. ROYAL SHIPP, SENIOR SPECIALIST, SOCIAL
LEGISLATION, CONGRESSIONAL RESEARCH SERVICE, LIBRARY
OF CONGRESS**

Mr. SHIPP. Thank you, Mr. Chairman.

I was asked to briefly discuss a few major conclusions regarding the Social Security program that come from a study completed last year by a team of analysts from the Congressional Research Service and the Congressional Budget Office for the Committee on Ways and Means.

Chairman Rostenkowski wrote in mid-1986 asking for this study. He requested background information, data, and an analytical frame work for understanding the issues raised by the retirement of the baby boom.

A team of analysts from CRS and CBO worked for a year, from the summer of 1986 to mid-1987, discussing issues, deciding on an analytic approach, and preparing a series of background papers. These papers included the role of economic growth, analysis of demographic projections, analysis of dependency ratios, sources of individual savings, Social Security and pension issues, and paying further health care needs of the baby boom in old age.

These papers and a subsequent overview of the entire report were published by your committee in the fall of 1987.

My testimony will summarize important conclusions we reached concerning the Social Security program. These points are made in more detail in a statement that I would ask be made part of the record.

Mr. Hartman will discuss one of the central conclusions of the study, emphasizing the importance of economic growth in preparing for the baby boom's retirement.

I will discuss four points. First the CRS/CBO study concluded that to refer to the retired population as a burden on the economy or on taxpayers is incomplete and misleading. During their careers, workers contribute to the growth of the economy through their savings and work efforts. At the same time, workers are building claims in the form of Social Security and pension rights that they can draw upon when they retire. Their contributions to the economy while working give legitimacy to their claims against the economy when they retire.

This is an important point. Recognizing at the same time that the resources consumed by retirees must come from contemporary production, it is the size of the economy and its health that makes it possible for retirees to cash in their retirement income claims that they built up while they were working.

A second point is the inevitability of the aging of the population. There is no way around this.

The baby boom will retire and will grow old, and when it does the percent of the gross national product that is required to pay Social Security benefits will inevitably increase.

At the present time, based on intermediate assumptions of the board of trustees, the Social Security benefits are about 4.7 percent of the gross national product. This percentage is declining according to the intermediate assumptions, and will continue to decline over the next several years, reaching 4.39 in the year 2005.

At that time the Social Security program will begin to rise as a percent of the gross national product, and will continue to rise over the next 30 years, reaching about 6.61 percent in the year 2035.

Now, as I say, there is no way around the increased resources going to the elderly when the baby boom retires. Whether the economy grows rapidly or more slowly, Social Security benefits will account for about 6.6 percent of GNP.

A third point from the study is to recognize the various sources of income to the elderly population. In particular, major changes in amount and in sources of income to the elderly took place within the last two decades.

The amount of aggregate income going to the elderly population increased, between 1967 and 1984, by 140 percent. Even adjusting for population growth, real per capita income during that period increased by about 40 percent.

The second point is that the sources of income to the elderly changed substantially between 1967 and 1984. Social Security in both years accounted for the largest share of income, and increased its relative share from 34 percent in the earlier year to about 38 percent in 1984. Private pensions also increased slightly.

But the big shift took place in the difference between earnings and income from assets during those 2 years. Earnings declined as a source of income to the elderly, from 29 percent of the total in 1967 to 16 percent in 1984.

And, at the same time, income from financial assets increased from 15 percent of total elderly income in 1967 to nearly 30 percent in 1984.

One conclusion from the data reported in the study is that people retire early if they can afford to; early retirement in the last several years has been possible because people enjoyed high level of retirement income.

Given the analysis we did of the education of the baby boom generation in comparison with others, there is reason to think that perhaps work would be more attractive at later years for many of this generation, particularly if economic growth during intervening periods does not support the kind of retirement income that would induce them to retire.

A final point is one your committee always considers in dealing with Social Security issues. Changes in Social Security must be made with appropriate time for implementation, and to allow people to adjust their work behavior, their savings behavior, and their expectations.

On the other hand, there is time to make adjustments if the Congress thinks they are necessary. The baby boom does not reach age 65 for 25 more years, and then not all at once. The baby boom will reach old age over a period of two decades.

A final point is that some changes that would help accommodate economic pressures from the baby boom's retirement would be incremental and would happen because of private incentives. For example, a trend to longer work lives, if necessary, is one that would happen automatically as people responded to economic conditions.

Thank you very much.

Chairman JACOBS. Thank you very much.

[The statement of Mr. Shipp follows:]

Statement
of
P. Royal Shipp
Senior Specialist in Social Legislation
Congressional Research Service

I. INTRODUCTION

Few things about the future are as certain as the coming large increase in the elderly population--particularly when the baby-boom (the generation born in the two decades between the mid-1940s and the mid-1960s) reaches old age. According to one set of data, the Census Bureau's intermediate projections, the number of people age 65 and over will double from 25.5 million in 1980 to 51.4 million in 2020, about a decade after the first of the baby-boom has reached age 65. By the time the last of the baby-boom reaches old age the number will have soared to 70.1 million. (See figure 1.) An unprecedented number of elderly and retired people in the next century will put pressure on the adequacy and affordability of the Nation's retirement income policies and programs.

This testimony briefly summarizes concepts and conclusions from a study requested and later published by the Committee on Ways and Means. The Committee asked for a study that would examine the implications of the baby-boom's aging on national retirement income policy. In response, a team of analysts from the Congressional Research Service and the Congressional Budget Office worked together for a year, completing the study last fall. The Congressional Research Service/Congressional Budget Office team analyzed demographic and actuarial data on sources of income to the elderly, including private pensions, Social Security, savings, and earnings; and issues in paying for the baby-boom's medical care. While the study was wide ranging, most of this testimony is about the Social Security program.

The study concluded that Social Security seems to be working as Congress intended. At present, its cost as a percent of the Gross National Product is declining and under current projections will continue to do so until the year 2005. Financing pressures on the Social Security program can emerge in future years, but if Congress needs to address financing pressures (or to respond to other issues that come up) there is time to do so. Changes in Social Security (and other retirement programs) should ideally be made with long implementation periods. However, the oldest of the baby-boom do not reach old age for nearly a quarter of a century, and then not all at once, but extending out for an additional 20 years.

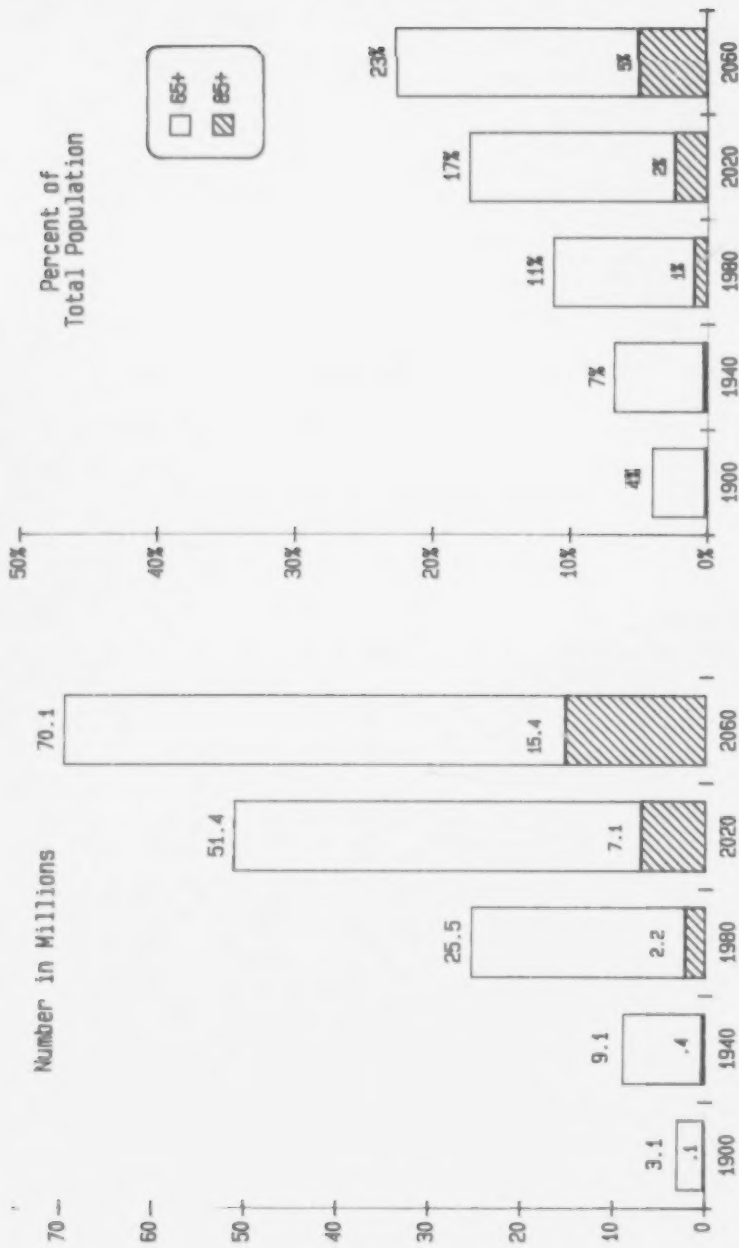
Furthermore, private sector and Government institutions respond flexibly to changing economic and social conditions. For example, the relatively well-educated baby-boom generation may continue working to later ages in an increasingly service oriented economy--particularly if economic growth during their working years does not provide them with what they consider to be adequate levels of retirement income.

Paying for the baby-boom's health care in old age raises different issues from retirement income. Social Security and Medicare are often analyzed together, but there is no inherent reason for doing so. Both programs are part of the Social Security Act and both rely at least partially on the payroll tax for paying benefits, but program costs are driven by different phenomena. Medicare and Medicaid expenditures respond to conditions in the health care industry and the costs of the Government's health financing programs for the elderly, the disabled, and some of the poor reflect trends in overall health industry costs.

The number of elderly reaching age 85 is growing at an even faster rate than is the number reaching age 65, and this by itself constitutes a serious challenge to the Nation's medical care system. People in this age group disproportionately suffer from chronic illnesses requiring long-term nursing home or other care, often do not have a spouse to help care for them, are disproportionately women who were not in the labor force in earlier years, and often are poor. Medicare, the health insurance program for the population over age 65, pays little for long-term nursing home or other care for chronic illness. Private health insurance policies within the financial reach of most elderly have not been forthcoming to date. Medicaid, a Federal/State program designed to finance medical care for the poor, now buys about one-half of aggregate nursing-home care, but this program requires individuals to "spend down" their assets to qualify.

Figure 1. The Increasing Elderly Population

(U.S. Bureau of the Census Projections)



The United States spends a larger share of its Gross National Product on health care than do other industrialized nations. This percentage has more than doubled in the past quarter century, from 5.3 percent in 1960 to an estimated 11.2 percent in 1987. If health care price increases continue to exceed price increases in the remainder of the economy at the rate they have over the past decade, the United States will be allocating 15 percent of its Gross National Product to health care by the year 2000--long before the baby-boom retires. Whether this, or any other percentage is too large, not large enough, or just right is the subject for other hearings (and studies).

II. PAYING FOR THE BABY-BOOM'S SOCIAL SECURITY

The remainder of the testimony focuses on ideas about earning and paying for the baby-boom's Social Security benefits. It considers first, how claims for future retirement income are built up during a work career. Second, it discusses ways to measure the effect of the baby-boom's retirement on the over-all economy. Then the testimony raises the possibility that earnings could account for a larger share of the elderly's future income than they do today. And finally, the section notes that the Nation's institutions and policies may adjust incrementally to accommodate the baby-boom's retirement.

A. Building Claims for Retirement Income

While workers are in the labor force, their savings and work contribute to the growth of the economy. At the same time, workers build up claims for retirement income from Social Security and pensions that can be "cashed in" after they retire and used to purchase goods and services. In addition, individuals save for retirement through investments, including homeownership, that are separate from their employment-related pensions and Social Security. In aggregate, retirement income from these other savings, while less than Social Security, exceeds benefits from pensions and other employer-sponsored plans.

Most projections of future claims from Social Security and pensions assume rising real wage levels. If this assumption holds, future retirees will have a higher standard of living than the elderly of today. Thus, the rate of productivity growth during a cohort's working lifetime determines its prosperity in retirement, relative to previous generations, and this growth also builds the base for future economic activity.

Building up the Nation's productive capacity over the next quarter century should ease the economic pressure of providing for the baby-boom's retirement. Then real Gross National Product (per worker) would be high enough to offset the expected decline in the workforce relative to the retired population, providing adequate real income for both groups. To achieve this buildup, national policy should tilt toward, or at least not hinder, a high investment economy in the period from now to 2010. This would require increases in saving and productivity growth because both are below historical rates at a time when, to prepare for the retirement of the baby-boom, above average rates appear warranted. Among policies to raise saving, increased saving by the Federal Government (in the form of reductions in the budget deficit) is the most likely to have a major impact. Policies to raise private saving may also be helpful but have not been notably successful in the past. (Robert Hartman's testimony will discuss the economic and budgetary aspects of these fiscal policy issues in greater detail.)

B. The Cost of Retirement Income

As the number of elderly people grows rapidly, particularly during the years of the baby-boom's retirement, the cost of paying their retirement benefits will grow also. Over the years, analysts have developed measures designed to assess the impact of these cost increases on the rest of the economy.

Some measures of the economic effects of Social Security and pension programs, often called "dependency ratios," compare the number of elderly to the working age population and suggest that economic pressure will mount because the elderly are becoming an increasingly large segment of the population. Dependency ratio measures, though useful for some purposes, can be misleading.

They suggest that the elderly are "dependent" on the working-age population when, in fact, both workers and retirees have claims against the productive capacity of the economy. In addition, dependency ratios ignore important variables such as economic growth and productivity improvements, and by themselves do not reflect the ability of society to care for its dependent populations. Comparisons of total benefit payments to the Gross National Product shift analytical attention to an assessment of the size of Social Security benefits compared to the overall economy. This ratio measures more accurately the economic pressure of paying for the baby-boom's retirement income.

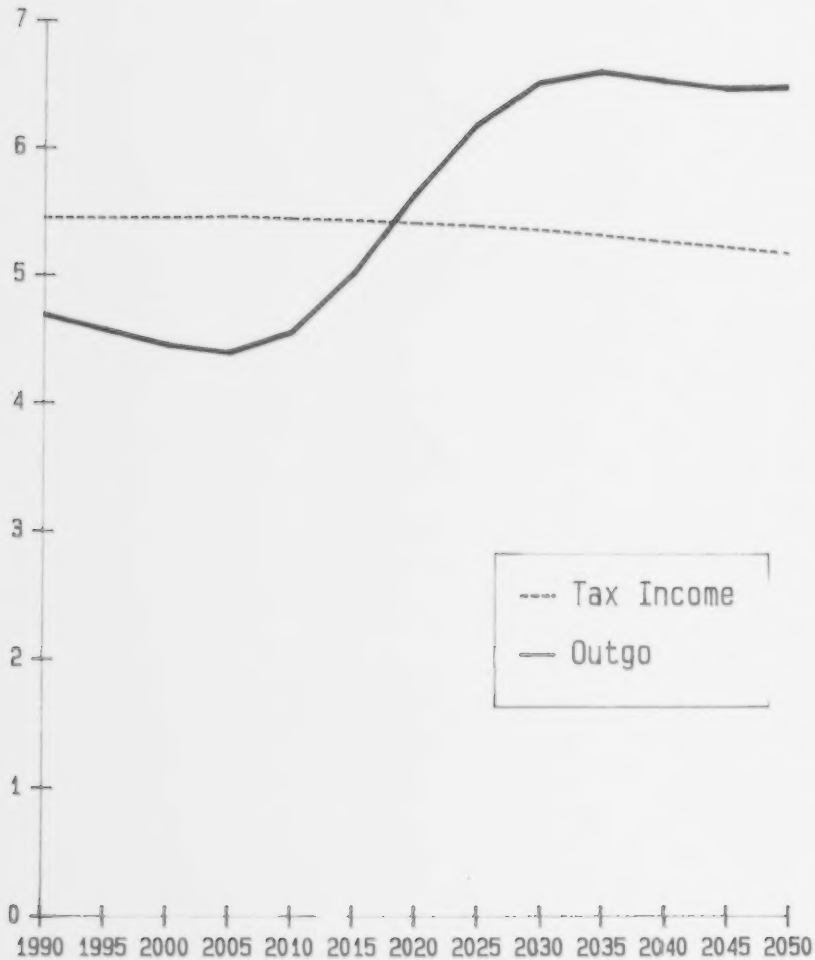
In 1983, Social Security payments reached 5 percent of the Gross National Product--its highest level to date. By 1988 this percentage had declined to 4.70 percent, and the Social Security Board of Trustees' intermediate projection shows continued decline over the next two decades to 4.39 percent in 2005. This decline is due to the large number of baby-boom workers in the labor market and the relatively low number of new retirees--those born during the depression years of the 1930s. As the population ages and the baby-boom begins retiring, however, the cost of providing their Social Security benefits will grow by 51 percent over a 30-year period, reaching 6.61 percent of Gross National Product in 2035. (See figure 2.) (Under the Trustees' most optimistic assumptions the percentage in 2035 would be 5.50 and under the most pessimistic assumptions it would be 8.11.)

In assessing the economic pressure from the baby-boom's retirement, emphasis on Social Security's cost as a percent of Gross National Product seems appropriate. However, it does not tell the whole story because many complex and difficult political and economic issues are raised in financing these benefit costs. In fact, much current attention is focused on the budgetary and economic implications of a Social Security trust fund that is projected to become very large. The financing techniques of both Social Security and Medicare will generate policy and legislative concerns even before the baby-boom retires.

Major Social Security Amendments enacted in 1977 and 1983 shored-up Social Security's short-run and long-run financing. These amendments included constraints on benefit growth and increases in Social Security's payroll tax to take effect in 1988 and 1990. The combined payroll tax (on both employees and employers) climbed to 12.12 percent in 1988 (from 11.4 percent in 1987) and will increase further to 12.4 percent in 1990. These payroll tax increases take effect at the very time that Social Security benefit payments (compared either to the Gross National Product or to total taxable payroll) are declining. During the next 30 years, revenues from Social Security's payroll taxes are projected to exceed benefit payments by large amounts, thus building up Social Security's trust fund balances to unprecedented levels (under the intermediate projections, they will reach a high point of approximately two-and-one-half trillion dollars in about 2020, in 1987 dollars). This trust fund build-up, if realized, would occur before the baby-boom's retirement. Its potential effect on the economy is being brought under close analytical scrutiny, particularly as a source of savings.

In the absence of policy changes, the surplus payroll taxes building up in the trust fund are "borrowed" to help run other Government operations. Under current practices these surpluses would allow the Government to borrow less from other sources, to increase spending or lower taxes, or some combination of these effects. In other words, the financing plan adopted in 1983 is projected to generate surplus payroll tax revenues until about 2016 that would either help finance other Government operations or reduce the national debt held by the public during this period. Then, during subsequent years of trust fund decline, other sources of Government revenues (including Federal borrowing) would be required to help finance Social Security as payroll taxes become insufficient to pay benefits and the debt held by the trust funds is redeemed to pay current benefits.

Figure 2.
Social Security Trust Fund
Income and Outgo
As a Percent of GNP
1990-2050



Source: Social Security Administration. 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Trust Funds.

One alternative to the current-law financing plan would be to peg the payroll tax more closely to the annual outlays of Social Security, which would mean that the payroll tax rate would actually decline during the next 20 years, and then increase steadily for the 30 years after that to a projected 16.25 percent in 2035. Another alternative would be the explicit infusion of general revenues into the system, particularly during the peak years of the baby-boom's retirement. Regardless of the method of financing, the cost of paying benefits will be met from society's production of goods and services at the time the claims are drawn down, not from a trust fund savings vault.

These same factors affect retirement claims that workers accumulate in the private sector through employer-sponsored plans or through their own savings, including homeownership. As with Social Security, the accumulation of private retirement wealth depends on underlying trends in employment and productivity during the period of accumulation. So too, the final value of retirement wealth depends on the capacity and willingness of society in the future to honor the contracts and debt instruments in which that wealth is embodied.

Trust fund issues are important, and the Congressional Research Service/Congressional Budget Office report discussed them in considerable detail. Time does not permit, during this testimony, to analyze alternative methods for financing future Social Security claims. Instead, the points below summarize some of the study's conclusions:

- (1) the cost of paying future benefits will have to be met from taxes and production of goods and services in the year the benefits are paid, regardless of the method of financing and the size of any trust fund;
- (2) different financing techniques will have different effects on income distribution;
- (3) a financing technique should be chosen to promote optimal levels of economic growth, but any technique must recognize the political importance of maintaining the people's trust in the system's future; and
- (4) the current low trust fund buildup is not inevitable, and Congress has the flexibility to modify it if the need arises.

C. Earnings as A Source of Income to the Elderly

Retirement ages since World War II have declined steadily. Based mainly on extrapolations of past experience, official projections assume that early retirement will continue into the future. However, workers have control over their retirement age and in the future could choose to work longer.

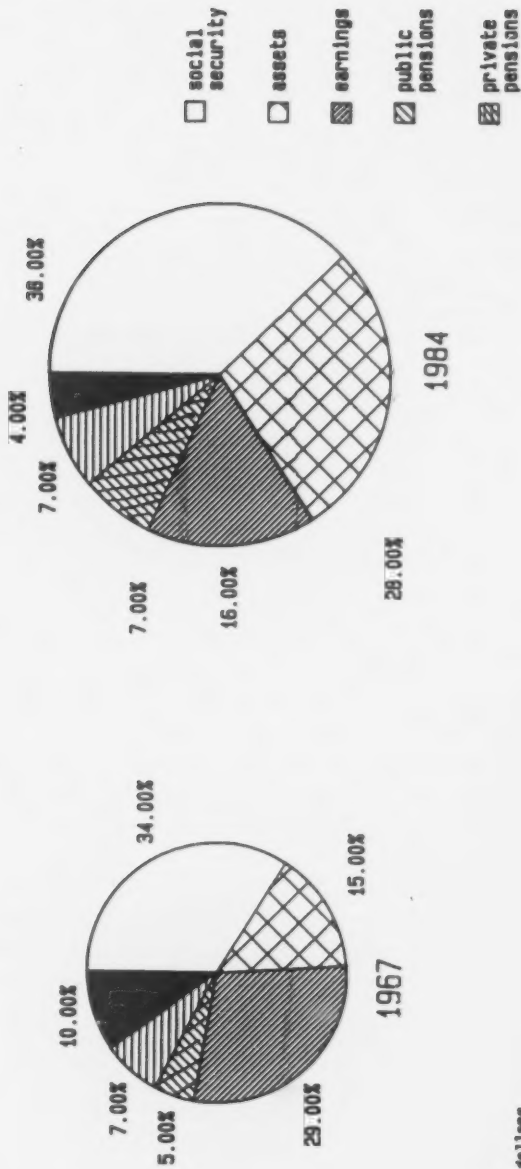
Decisions to retire are strongly influenced by levels of retirement income; people retire early if they can afford to. During 1967 to 1984 per capita real income (including earnings) of the elderly increased by 38 percent. These increases corresponded to the trend to early retirement during the same time. These recent retirees worked during years of rapid economic growth. Not only did their retirement income claims from Social Security and pensions grow, but they were able to accumulate financial assets. Furthermore, these financial assets generated large amounts of income when interest rates were high during the late 1970s and early 1980s. (See figure 3.)

If economic growth rates are high, retirement income claims will be large and current early retirement trends may continue. On the other hand, if economic growth rates are lower, retirement income claims will either be relatively lower or more difficult to honor fully. The elderly may have to choose whether to retire with a lower standard of living than they would have achieved under more favorable economic conditions, or to work longer. Earnings could become a greater source of income received by the elderly--as they were two decades ago.

Figure 3

Income Shares of Aged Households a/

(All units, including married couples and nonmarried individuals)



a/ In 1984 dollars

Source: Income of the Population of 65 and Over (1976-1984) and Demographic and Economic Characteristics of the Aged: 1980 Social Security Survey, U.S. Department of HHS.

D. Adjusting Incrementally

Work and saving patterns, private markets, and political institutions usually adjust incrementally to changing demographic and economic conditions if given sufficient time. Decisions to change the structure of retirement benefit payments under Social Security should be made well in advance of the effective date, to allow people to adjust their economic behavior and expectations over an extended period. Similarly, if the Congress were to decide to provide greater amounts of publicly supported long-term health care, decisions well in advance of the effective date would ease the financing burdens and would allow time for supply adjustments by providers. At the same time, the oldest of the baby-boom just entered their 40s and will not reach age 65 for nearly one-quarter of a century. Furthermore, the baby-boom doesn't reach old age all at once, but gradually over two decades.

Given these time horizons, future Congresses will consider proposals to reduce or increase the level of Social Security benefits as they see the necessity for doing so. Until the mid-1970s, Congress consistently increased benefits for future Social Security recipients, but since the mid-1970s has generally constrained their growth. Most recently the 1983 Social Security amendments constrained benefit growth, both in the short and the long run. Furthermore, the level of benefit obligations earned by the baby-boom will vary directly with rates of overall economic growth. And if a worker shortage develops because of the "birth dearth" that followed the baby-boom, rising wage rates could induce older workers to stay in the labor force longer.

In the final analysis, a worker's retirement claims are only as good as the Nation's economic well-being, its traditions of obligation and trust, and the absence of conflicting priorities of overwhelming urgency. If the United States and its economic partners can successfully manage the global economy, incremental policy changes emerging from future political debates should be sufficient to accommodate retirement income needs of the baby-boom within the framework of current policies and programs.

Chairman JACOBS. Mr. Hartman.

**STATEMENT OF ROBERT W. HARTMAN, ACTING DEPUTY
DIRECTOR, CONGRESSIONAL BUDGET OFFICE**

Mr. HARTMAN. I have a longer version of my statement I would like to include.

Chairman JACOBS. Without objection.

Mr. HARTMAN. Mr. Chairman, I am pleased to appear before this subcommittee to discuss the economics of the baby boom's retirement. Over the next two decades, the number of people over 65 years of age will fall relative to the working population. For the subsequent two decades, the situation will reverse itself as the growth of retirement-aged people substantially exceeds that of the projected work force. In my testimony, I will examine what this pattern implies for the economy and specifically for Federal policy towards national savings and investment.

Assuming that members of the baby boom generation will begin to retire two decades from now, as projected by the Social Security Administration, there will at that time be a great many claimants on the U.S. capacity to produce—or import—consumer goods and services. Specifically, the baby boom generation will continue to claim its share of consumption just as it ceases contributing to that production.

Two major ameliorative factors would ease the pressure of competing demands for consumer goods:

If the economy's capital stock and productive potential grows rapidly by 2010, the work force would be capable of producing a much larger national output at that time, thereby making it easier to transfer a growing share to retirees.

U.S. citizens could have built up enough claims on foreigners by 2010 that U.S. productive capacity could be supplemented during the baby boom retirement years by a high level of imports, paid for by the previously accumulated claims.

What is common to both of these factors is that they would require that higher shares of GNP be devoted to savings and investment during the next two decades than in recent years. Growth in the U.S. capital stock and in net U.S. holdings of claims against foreign assets would mean higher levels of investment—domestic or foreign—by the United States.

The only way to obtain more investment is to reduce consumption of public or private consumer goods and services. In short, if the middle-aged United States today visited a financial planner, the bottom line of the computer printout would read: save more for retirement while you are still working.

The recent history and prospective outlook for the U.S. economy on the savings and investment front is not encouraging.

Indeed, we have been experiencing economic behavior that is very much the opposite of the high savings and investment scenario just described.

Private savings rates—by households, business and pension funds held by State and local governments—have deteriorated in the 1980s to well under the average following the Second World War. As the baby boom enters late middle age in the next two decades,

private savings rates might be expected to rise to some degree, although that is an uncertain conclusion.

The story in the public sector is worse. The Federal Government, which can contribute to national savings by running an excess amount of income, taxes and other receipts—over outgo (outlays), has done quite the opposite. Federal deficits in the 1980s so far have averaged 4.4 percent of GNP compared with 1.1 percent over the previous 30 years. Under the CBO baseline, the deficit share is projected to average 2.9 percent of GNP between 1988 and 1993, reaching 2.1 percent of GNP in the final year. While this decline represents an improvement, it results in part from more rapid economic growth than can be expected in the future as the economy reaches full capacity. The underlying pace of lowering Federal deficits is slow.

Of course, the shorter-term trends in the Federal deficit do not preclude a vast turnaround in Federal finances before the baby boom begins to retire. We still have 20 years before that day arrives.

The CBO baseline methodology for 5-year projections provides a less satisfactory point of reference if it is blindly extended for another 15 years. On the revenue side, our current tax laws should yield about 19½ percent of GNP each year over the next 5 years, not far from the historical average. On the spending side, longer-term extrapolations would show that by 2000, under current law, entitlement spending would be about 11 percent of GNP, up slightly from the current 10.7 percent, with declining Social Security retirement costs being offset by rising Medicare and Medicaid spending.

Beyond revenues and entitlements, longer-term extrapolation of Federal outlays is largely guesswork about foreign military threats and domestic needs. Expenditures for national defense were as high as about 10 percent of GNP at the peak of the Vietnam war, fell to under 5 percent of GNP in 1980, and are now about 6 percent of GNP and falling.

Nondefense discretionary spending amounted to about 5 percent of GNP in the late 1960s and 1970s, but has dropped to under 4 percent currently. If the roughly 10 percent of GNP recently consumed by combined discretionary defense and nondefense spending is a reasonable guess for the longer term, then that projection reveals the difficulty before us.

With entitlements at 11 percent of GNP in the year 2000, an additional 10 percent for these discretionary programs, and an allowance for net interest, minus offsetting receipts, of 1.5 percent of GNP, outlay rates—around 22½ percent of GNP—will be well above the projected revenue share of just over 19½ percent in the longer run. In short, in the absence of policy change, the deficit could continue until the end of the century.

Discussions of the pros and cons of various deficit targets in the past have been dominated by short-run (cyclical) considerations.

While stabilization policy continues to be an important constraint on fiscal policy, the decidedly longer term savings and investment considerations discussed in this testimony raise the issue of what fiscal policy norms should be for the long run. To give definitive advice on such norms involves reaching settled conclusions

about a number of factors that are among the most unsettled areas of economic research.

Nonetheless, as attention has turned to longer run considerations and a sharp rise in the social security surplus, various fiscal norms have been mentioned.

One extreme would be a continuation of the budget policy of the postwar period, with continued deficits in the 1 to 1½ percent of GNP range. This might be thought of as a possible end product of the slow decline in deficits under current policy. During the early years of the next century, when Social Security surpluses grow very large, such a standard implies deficits in the rest of the budget as great as they were in the mid-1980s.

A second plan would be for a balanced Federal budget, as, for example, is incorporated in the final year of the Balanced Budget and Emergency Deficit Control Act Reaffirmation of 1987—or Gramm-Rudman-Hollings. Since the Social Security program under current law is projected to have large surpluses for the next 20 years, this norm implies that the rest of the government could remain in deficit, but just enough to offset growing Social Security surpluses.

Finally, at the opposite extreme is the goal of balancing the part of the Federal budget that does not include Social Security. The implication of this target is that the total government would save the amount now projected in the Social Security surplus under current law.

Deciding on where the Government should aim depends on the guesstimates about non-Federal savings and productivity changes, and on the relative importance assigned to easing the burden of the baby boom's retirement compared with the short-term losses in consumption that would result from any vigorous deficit-cutting regime.

Discussion of the critical issue of how an economy with a low saving rate is to be turned around appears to have been diverted into a discussion of how to display the Social Security accounts in the Federal budget.

Currently, Social Security is off budget as a result of the Gramm-Rudman-Hollings Act. However, in setting fiscal norms for the next 5 years, this same act requires that the Social Security accounts be incorporated into the budget deficit calculations, making Social Security, in practice, a part of—if not on—the budget.

Current projections show rising Social Security surpluses, but increasing deficits for the rest of the government as a whole.

Some contend that keeping Social Security off budget and setting fiscal goals exclusively for the remaining government accounts would help the Government do what is needed: raise taxes or lower spending. Others contend that nothing is wrong with including Social Security—which, in any event, cannot really be ignored—as long as ambitious goals, such as running a total government surplus, are not ruled out. Under this view, with a budget defined to be inclusive and the budget norms made flexible, the government would be acting on the most complete information.

The main difference between these views lies in their assessment of how political players will react to different budget presentations. In weighing these views, we have no direct historical evidence to draw upon—these social insurance surpluses are a new event in

our history—so all predictions about the behavior of the Congress, the President, and the electorate rest on speculation. Whatever the process and outcome of this debate, however, attention should not be diverted from the critical issues for national savings raised by the demographic changes taking place.

Chairman JACOBS. Thank you.

[The statement of Mr. Hartman follows:]

Statement of Robert W. Hartman
Acting Deputy Director
Congressional Budget Office

before the
Subcommittee on Social Security
Committee on Ways and Means
U.S. House of Representatives

May 10, 1988

Mr. Chairman, I am pleased to appear before this subcommittee to discuss the economics of the baby boom's retirement. Over the next two decades, the number of people over 65 years of age will fall relative to the working population. For the subsequent two decades, the situation will reverse itself as the growth of retirement-aged people substantially exceeds that of the projected work force. In my testimony I will examine what this pattern implies for the economy and specifically for federal policy towards national savings and investment.

Assuming that members of the baby boom generation will begin to retire two decades from now, as projected by the Social Security Administration, there will at that time be a great many claimants on the U.S. capacity to produce (or import) consumer goods and services. ^{1/} Specifically, the baby boom generation will continue to claim its share of consumption just as it ceases contributing to that production. Two major ameliorative factors would ease the pressure of competing demands for consumer goods:

- o If the economy's capital stock and productive potential grows rapidly by 2010, the work force would be capable of producing a much larger national output, thereby making it easier to transfer a growing share to retirees. Moreover, such a large capital buildup would allow a major diversion of resources during the baby boom retirement years out of investment goods and into the consumer goods sector.
- o U.S. citizens could have built up enough claims on foreigners by 2010 that U.S. productive capacity could be supplemented during the baby boom retirement years by a high level of imports, paid for by the previously accumulated claims.

What is common to both of these factors is that they would require that higher shares of GNP be devoted to savings and investment during the next two decades than in recent years. Growth in the U.S. capital stock and in net U.S. holdings of claims against foreign assets would mean higher levels of investment (domestic or foreign) by the United States. The only way to obtain more investment (public or private) is to reduce consumption of (public or private) consumer goods and services. If the middle-aged United States today visited a financial planner, the bottom line of the computer printout would read: save more for retirement, while you are still working.

1. The possibilities of delayed retirement in the baby boom generation are discussed in the accompanying testimony of Royal Shipp.

How Are We Doing?

The recent history and prospective outlook for the U.S. economy on the savings and investment front is not encouraging. Indeed, we have been experiencing economic behavior that is very much the opposite of the high savings and investment scenario just described.

Private savings rates--by households, business and pension funds held by state and local governments--have deteriorated in the 1980s to well under the average following the Second World War. This decline happened despite very high real interest rates, numerous tax subsidies to encourage savings, and a recent reduction in the number of young adults who traditionally are low savers.^{2/} As the baby boom enters late middle age in the next two decades, private savings rates might be expected to rise to some degree.

The story in the public sector is worse. The federal government, which can contribute to national savings by running an excess of income (taxes and other receipts) over outgo (outlays), has done quite the opposite. Federal deficits in the 1980s so far have averaged 4.4 percent of GNP compared with 1.1 percent over the previous 30 years. This means that federal borrowing is increasingly competing for dwindling private savings, rather than augmenting them. (Such behavior by the federal government would be of little concern in a savings and investment context if the growing deficit were attributable to growing federal outlays for education, training, and infrastructure, for these also contribute to future productivity. But the growth in the deficit cannot be attributed to such factors.)^{3/} State and local governments have run an approximately balanced budget (except for the pension reserves mentioned above), and this situation can be expected to continue.

The Congressional Budget Office's (CBO's) latest five-year baseline projection--showing the course of the deficit under current policy--is only mildly encouraging. These baseline projections are not forecasts of future budgets, which will doubtless include numerous policy changes, but are a benchmark against which to judge the budgetary consequences of proposed legislation. From an average deficit of 4.4 percent of GNP in the first seven fiscal years of the 1980s, the deficit share is projected to average 2.9 percent of GNP between 1988 and 1993, reaching 2.1 percent of GNP in the final year.^{4/} While this decline represents an improvement, it results in part from more rapid economic growth than can be expected in the future as the economy reaches full capacity. The underlying pace of lowering federal deficits is slow.

Recent trends in U.S. economic relations with the rest of the world are also the reverse of what would help in preparing for the baby boom's retirement. When I referred earlier to building up claims against foreign assets over the next 20 years, that is equivalent to exporting more goods and services than we import during that time. A current export surplus means that foreigners would be increasing their

2. For a discussion of some of the tax incentives and a useful bibliography, see Edward Gramlich and Eric Toder, "The Impact of Tax Reform on Savings and Investment: Some Early Evidence," National Tax Association-Tax Institute of America, *Proceedings of the Eightieth Annual Conference, 1987* (forthcoming).

3. See Congressional Budget Office, *Trends in Public Investment* (December 1987).

4. Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1989-1993* (February 1988).

debt to U.S. residents--which is another way of saying we would be increasing our claims on them.

Recent history shows exactly the opposite behavior in the foreign sector of the U.S. accounts. In 1987, the U.S. imported \$141 billion more than it exported, continuing a string of five years of increasingly disappointing foreign trade performance. Should the United States not reverse its net debtor position in the next 20 years, we would face the prospect in the baby boom retirement years of having to divide the U.S. national output not only among the work force and its children and the growing ranks of the retired, but also of having to send part of it abroad, as foreign holders of U.S. assets cash in their dividends and interest. Some improvement in the foreign sector accounts appears likely. Foreign private investors have already shown flagging interest in dollar-denominated securities, and exports are rising. However, without an increase in domestic savings a decline in foreign capital inflows will manifest itself in declining domestic investment--once again, an outcome that would work against preparing for the baby boom's retirement.

Longer Perspectives on the Deficit

Of course, the shorter-term trends in the federal deficit do not preclude a vast turnaround in federal finances before the baby boom begins to retire. We still have 20 years before that day arrives.

The CBO baseline methodology for five-year projections provides a less satisfactory point of reference if it is blindly extended for another 15 years. On the revenue side, our current tax laws should yield about 19 1/2 percent of GNP each year over the next five years, not far from the historical average. Beyond that time, personal income tax revenues as a share of GNP should rise slightly as real growth causes some bracket creep. (Certain excise taxes, however, that are levied on a per-item basis tend to shrink as a share of GNP.) Whether "current policy" incorporates such an upward creep or really is the 19-1/2 percent share envisioned in the next few years is an unanswerable question. On the spending side, longer-term extrapolations would show that by 2000, under current law, entitlement spending would be about 11 percent of GNP (up slightly from the current 10.7 percent), with declining social security retirement costs being offset by rising Medicare and Medicaid spending.^{5/} The latter extrapolations are especially uncertain, however, because they depend on assumptions about medical care prices and about almost certain changes in federal policy, such as physician reimbursement.

Beyond revenues and entitlements, longer-term extrapolation of federal outlays is largely guesswork about foreign military threats and domestic needs. Expenditures for national defense were as high as about 10 percent of GNP at the peak of the Vietnam War, fell to under 5 percent of GNP in 1980, and are now about 6 percent of GNP and falling. Nondefense discretionary spending amounted to about 5 percent of GNP in the late 1960s and 1970s, but has dropped to under 4 percent currently. If the roughly 10 percent of GNP recently consumed by combined discretionary defense and nondefense spending is a

5. See statement by Paul N. Van de Water, Chief, Projections Unit, Congressional Budget Office, to be given before the Subcommittee on Social Security, Senate Committee on Finance, May 13, 1988.

reasonable guess for the longer term, then that projection reveals the difficulty before us. With entitlements at 11 percent of GNP by 2000, an additional 10 percent of GNP for discretionary spending, and an allowance for net interest (minus offsetting receipts) of 1.5 percent of GNP, outlay rates (around 22 1/2 percent of GNP) will be well above the projected revenue share of just over 19 1/2 percent in the longer run.

Too often, analysts have taken CBO's short-term methodology--which is to hold discretionary spending constant in real terms--and extended it to the distant future to arrive at pleasing conclusions. But not allowing discretionary programs any part of an assumed real growth in GNP is a severe assumption, implying a constantly shrinking public goods share of GNP. Under the alternative assumption of fixed GNP shares employed above, the prospect is less pleasing: in the absence of policy change, the deficit could continue until the end of the century.

A Long-Term Target for the Deficit

Discussions of the pros and cons of various deficit targets in the past have been dominated by short-run (cyclical) considerations. While stabilization policy continues to be an important constraint on fiscal policy, the decidedly longer-term savings and investment considerations discussed in this testimony raise the issue of fiscal policy norms for the long run.

To give definitive advice on such norms involves reaching settled conclusions about a number of factors already alluded to. Since total national savings affects investment, a clear idea about private savings rates would help to settle on optimum public saving rates. And since the ease of transferring output from the working population to the elderly depends on the level of real output, we would need to know the various noninvestment factors--managerial improvements, innovations, mobility of the population, and so forth--that contribute to output. For the most part, these factors are among the most unsettled areas of economic research. Saving rates of different age groups have proven hard to predict and explanations of past output growth have not satisfactorily explained all of the productivity slowdown suffered (all over the developed world) since the early 1970s.

Nonetheless, as attention has turned to longer-run considerations and to an impending sharp rise in the Social Security surplus, various fiscal norms have been mentioned. (In the following discussion--as in all of the previous parts of this testimony--"the deficit" or "the budget" means the total federal deficit, including social security.) In order of increasingly ambitious plans:

- o One extreme would be a continuation of the budget policy of the postwar period, with continued deficits in the 1 percent to 1-1/2 percent of GNP range. This might be thought of as a possible end product of the slow decline in deficits under current policy. During the early years of the next century, when Social Security surpluses grow very large, such a standard implies deficits in the rest of the budget as great as they were in the mid-1980s.
- o A second plan would be for a balanced federal budget--as, for example, is incorporated in the final year of the Balanced Budget and Emergency Deficit Control Act Reaf-

firmation of 1987 (Gramm-Rudman-Hollings). Since the Social Security program under current law is projected to have large surpluses for the next 20 years, this norm implies that the rest of the government could remain in deficit, but just enough to offset growing Social Security surpluses.

- o At the opposite extreme is the goal of balancing the part of the federal budget that does not include Social Security. The implication of this target is that the total government would save the amount now projected in the Social Security surplus under current law.

With the huge Social Security surpluses now projected, there are clearly several intermediate stopping points between the extremes besides a balanced budget. Deciding on where the government should aim depends on the aforementioned guesstimates about nonfederal savings and productivity changes, and on the relative importance assigned to easing the burden of the baby boom's retirement compared with the short-term losses in consumption that would result from any vigorous deficit-cutting regime.

On-Budget Versus Off-Budget: Is that the Question?

Discussion of the critical issue of how an economy with a low saving rate is to be turned around appears to have been diverted into a discussion of how to display the Social Security accounts in the federal budget.

Currently Social Security is "off-budget" as a result of the Gramm-Rudman-Hollings Act. However, in setting fiscal norms for the next five years, this same act requires that the Social Security accounts be incorporated into the budget deficit calculations, making Social Security, in practice, a part of--if not on--the budget. Current projections show rising Social Security surpluses, but increasing deficits for the rest of the government as a whole.

Some contend that keeping Social Security off-budget and setting fiscal goals exclusively for the remaining government accounts would help the government do what is needed: raise taxes or lower spending. Others contend that nothing is wrong with including Social Security (which, in any event, cannot really be ignored) as long as ambitious goals, such as running a total government surplus, are not ruled out. Under this view, with a budget defined to be inclusive and the budget norms made flexible, the government would be acting on the most complete information.

The main difference between these views lies in their assessment of how political players will react to different budget presentations. In weighing these views, we have no direct historical evidence to draw upon--these social insurance surpluses are a new event in our history--so all predictions about the behavior of the Congress, the President, and the electorate rest on speculation. Whatever the process and outcome of this debate, however, attention should not be diverted from the critical issues for national savings raised by the demographic changes taking place.

Chairman JACOBS. Mr. Chandler.

Mr. CHANDLER. Thank you.

If you don't mind, I would like to ask some questions.

Mr. Hartman, under a pure economic model, do you consider the deposits to the trust fund right now as savings or consumption?

Mr. HARTMAN. The usual way of accounting for total national savings adds up private savings and government savings. Government savings is the difference between all taxes collected and all expenditures, so it would include payroll taxes on the receipt side and it would include Social Security benefits on the expenditure side. Part of the trust fund receipts is interest, which is neither one of these two, but that is largely a canceling item. It is a payment from the rest of the government to the trust fund and would not show up in this accounting. It cancels out.

Mr. CHANDLER. The thing I am trying to get at, and I think a lot of my constituents, especially those my age and younger are worried about, is will there be any money in those trust funds—IOWs, yes, we understand that—but will there be any money there in 2015, 2020 when those trust funds balances are needed to make up the difference between what is now a cash surplus each year and what will then be a cash deficit.

For example, if we were to not purchase Treasury bills now with those so-called surpluses in the Social Security Trust Fund, but invest them in foreign securities, wouldn't there be a significant difference in the economic consequences of doing that?

In other words, Japanese and German and taxpayers would have to repay those trust funds, not American taxpayers. Or am I just so totally confused—

Mr. HARTMAN. Well, the trust fund assets are held entirely in Treasury securities. If we believe the Social Security trustees intermediate projections, there is plenty of money to meet all obligations through a period going out to about 2048, something of that sort.

Those Treasury securities are really as good as money I think in any sense. The trust fund would simply cash them in when they needed them at the time when tax receipts weren't sufficient to meet benefit obligations. So I think the basic answer is yes, these resources do exist.

Moreover, I would point out the basic promise that we have made to Americans is that they are entitled to certain benefits that are determined by a formula based on their past wages, and so on. Should the trust fund somehow run out of money, the government would face the situation where it could supplement the trust funds with other sources of revenues or reductions in other expenditures. As long as we believe the promises we make on the benefit side are true, I don't think there is any reason for citizens to be worried about the availability of funds.

The question of alternative ways of the trust fund deploying its assets—that is, holding it in Treasury securities versus foreign bonds versus U.S. equities, versus other things—is actually a topic that I would guess that Mr. Aaron is going to address. In a recent report to the trustees, the Brookings team of analysts did look at this, and if I am not misrepresenting them, their contention is that the mix of assets doesn't make a very big difference in terms of

how the total economy would operate or on the viability of the Social Security program, and I think he would be able to explain it better than I could.

Mr. CHANDLER. You make the point that when those assets are needed, the Social Security Trust Fund managers would cash in those Treasury bills.

What would be the source of the cash to reimburse the trust fund?

Mr. HARTMAN. The Treasury.

Mr. CHANDLER. What is their source of fund?

Mr. HARTMAN. Ultimately, tax revenues.

Mr. CHANDLER. Which would be running a surplus at that time to make up the difference?

Mr. HARTMAN. That is the \$64 billion question.

Mr. CHANDLER. Oh, okay.

Now we are getting to the root of my question, which is that we are reassured that the funds are there, yes, an IOU, but who will ultimately have to pay or repay the trust fund?

Now, I realize this is reaching, but if you had deposited the funds in foreign treasuries, for example, Japanese or German, then it would be their taxpayers who would have to refund, would have to come up with the cash for the trust funds, not American taxpayers.

So there would be a very significant difference in the economic effect.

Mr. HARTMAN. I believe you still have to go through the Treasury. The Treasury would then have to dispose of the foreign securities.

It really assumes, depends on what you assume overall fiscal policy will be in the year 2030.

I misspoke a minute ago. Borrowing is another source of money for the Treasury. It could borrow at that time as well as raise taxes. But we know there is presumably some limit to this, but a deficit may then be an appropriate policy, a much more sensible policy at that time than it is right now, as a matter of fact.

Mr. CHANDLER. Thank you.

Thank you, Mr. Chairman.

Chairman JACOBS. Mr. Hartman, during a 2-year period beginning in 1984, as I understand it, our Nation was transmogrified from the greatest creditor nation to the greatest debtor nation on Earth.

Why in those 2 years? What suddenly happened?

Mr. HARTMAN. We had a continuing trade deficit that is now in about its sixth year and it reached extremely high levels each year. Last year the trade deficit was on the order of \$140 billion. And we simply worked down our net balance of claims on foreigners by this annual consumption of imports in excess of what we were exporting. If you take out \$150 billion per year, you work down what you started with pretty fast. So we switched over to being a net debtor and at the current rate of deficit, or even at slightly lower rates, we will be in enormous debt in relatively few years.

What happened has to do, I think, with comparison of American growth rates and our absorption of imports. This was a period the economy was recovering from the deep recession early in this decade. There were slower foreign growth rates that inhibited the

import of American goods, plus an exchange rate that at that time produced a situation where American securities were very attractive to foreigners. So we had a rush on the purchase of American securities, as well as a shortfall on the trade account.

Chairman JACOBS. By American securities, do you mean private securities or public securities or both?

Mr. HARTMAN. It was both. And at that time it was mainly financial assets, a lot of them government securities, but a lot of them private bonds too. Within the last 18 months or so, there has been a lot more private direct investment in the United States. For example, real estate—the articles you read about, the Japanese purchases of hotels and assets like that.

Chairman JACOBS. Wasn't there a sudden and significant increase in the sale of U.S. deficit, government bonds to foreign nationals during that 2-year period?

Mr. HARTMAN. My recollection is that the fraction that was in government, in Federal debt, was not unusual compared with the past fraction. But that is not something I am entirely sure of at the moment.

Chairman JACOBS. Are you familiar with the Deficit Reduction Act of 1984 as a repeal of taxation on foreign nationals' income from the investment in the United States?

Mr. HARTMAN. Only slightly. I am only slightly familiar with that provision.

Chairman JACOBS. I think that is true of the rest of the country too and most Members of Congress. It was inserted, I would say, furtively in the conference report in 1984, and the net result is that the U.S. Government is paying "mafio" interest rates on its bonds to foreigners, which is to say higher interest to foreign nationals than it will pay to its own citizens. Are you aware of that, the repeal of the 30 percent withholding?

Mr. HARTMAN. No.

Chairman JACOBS. I think we all ought to study up on it. It might be surprising. It is probably one of the slickest political tricks I am aware of in the history of the Republic toward that age-old dream of alchemy. We are today, as I say, paying much higher interest rates, for example, than Japanese businessmen on the same bonds you and I might buy and pay Federal income tax on, and I would appreciate really some response from the Congressional Budget Office. This seems to be a free-for-all generally about the economy and its impact upon the viability of the Social Security program to which Mr. Chandler referred, some responses to this strange coincidence that at the moment they review the taxation to which I referred. We started our rather precipitous downward slide into the inviable status of a pitiful helpless debtor nation, or whatever Mr. Nixon would call it.

Mr. HARTMAN. The key element here, if we leave out private capital flows for a moment, is that if we run a trade imbalance with an excess of imports over exports, foreigners are going to be left with an excess of dollars, in effect. That is—it is that imbalance that is ultimately the source of their ability to buy any kind of American security.

[The following was subsequently received:]

Withholding was repealed on interest paid on foreign portfolio debt investments issued after the enactment of the Deficit Reduction Act. However, very little of the interest paid to foreigners had previously been subject to withholding at the 30-percent statutory rate. The withholding rate was usually reduced by treaty on a reciprocal basis. The effective rate of withholding prior to repeal was probably less than 5 percent.

While a 5-percent withholding rate may seem low relative to U.S. tax rates, which used to be as high as 50 percent, in fact, it may not have been because withholding was imposed on gross interest income without adjustment for expenses. If, for example, a U.S. bank and a foreign bank both earned 10 percent interest on U.S. Treasury bonds that were purchased with deposits that paid 8 percent interest and both banks had administrative costs of 1 percent, then a 5 percent withholding rate on gross income would be equal to a 50 percent tax rate on net income.

The repeal of withholding on interest payments to foreigners clearly reduced U.S. tax receipts, but it probably reduced U.S. interest rates as well.

Chairman JACOBS. What about their ability to get a U.S. Government bond at higher interest rates than your ability to get one as an American citizen? Does that sound a little slick to you?

Mr. HARTMAN. Yes, it does.

[The following was subsequently received:]

The interest income that the U.S. pays to foreigners is subject to tax in their home country. Therefore, a foreign investor would only receive a higher after-tax return than his U.S. counterpart if the foreign country had a lower tax rate than the U.S. on interest income.

Chairman JACOBS. Is it not also true that classically, the Government borrowing increases, as it certainly has in this decade, interest rates. The impact upon the money markets in this economy of the United States will mean that interest rates will rise. Instead, after the 1984 general elections, rather than interest rates rising, they began to fall, or just before really the 1984 election. Wouldn't the bribery or the inducement of foreigners to buy U.S. bonds because of much higher interest rates than we pay our own citizens remove that pressure from money markets in the United States and create an aura of well-being in the average citizen seeing "sold" signs all over town, automobile sales doing, if not a brisk business, at least holding their own all of a sudden? Wouldn't that be pretty slick?

Mr. HARTMAN. I believe at no time during this period did foreign purchases of U.S. Government securities amount to anything like a majority of the market, so that there are a lot of other things going on in any given time that would be affecting—

Chairman JACOBS. My first question was: Is it a factor?

Mr. HARTMAN. A change in the taxation of income from U.S. securities should have an effect on the demand for them, yes, sir.

Chairman JACOBS. Mr. Shipp, you say people pretty much decide to retire when they are able to financially. I couldn't help thinking of Arthur Godfrey's old couplet, "Early to bed, early to rise, until you get enough cash to do otherwise."

We thank the panel very much for your contribution to the record.

Mr. Hartman, one omitted question, are you familiar with the proposal of our friend, Bob Myers, which I believe will be to reduce the Social Security tax somewhat? Have you an opinion concerning that proposal?

Mr. HARTMAN. I think there are two ways we would have to look at it. One—and the one that follows most closely what I was talk-

ing about—is if you literally did that, cut the payroll tax rate next year and did nothing else, that would significantly increase government dissaving. It would reduce——

Chairman JACOBS. Dissaving?

Mr. HARTMAN. Increase the deficit. Dissaving is the opposite of saving. It is spending more than you take in.

Chairman JACOBS. When you say increase dissaving, if you don't listen carefully, you might say "Hooray, that sounds good."

Mr. HARTMAN. It would not be conducive to what we need in order to prepare for this demographic burst. I believe Mr. Myers' position, however, derives from more narrow considerations about what he believes the payroll tax ought to be over time. Some people believe they ought to be kept as little changing over time as possible. Others believe that they ought to fluctuate with the number of claimants. I really have no opinion on it, but I think it is important to keep these two criteria in mind.

Chairman JACOBS. Thank you very much. The panel has made a useful contribution to the record.

Without further ado, we will introduce Robert Myers, former Chief Actuary, Social Security Administration; Alicia Munnell, senior vice president and director of research, Federal Reserve Bank of Boston; Henry Aaron, senior fellow, the Brookings Institution; and John L. Palmer, senior fellow, the Urban Institute.

Mr. Myers.

STATEMENT OF ROBERT J. MYERS, FORMER CHIEF ACTUARY, SOCIAL SECURITY ADMINISTRATION

Mr. MYERS. Thank you, Mr. Chairman.

I should first like to say a few words about the present financial status of the OASDI trust funds. I am very happy to say that they are in really great shape at the moment. To my prepared testimony, I have added two tables that compare the actual balances in the trust funds since 1983 with the estimates made when the 1983 amendments were adopted. At the end of 1987, the OASDI trust funds had a balance of \$69 billion. This is \$48 billion higher than shown by the cost estimate on which the financing was based—in other words, three times as high a fund balance. Even using the intermediate estimates, the fund balance actually is twice as high.

It should be noted, however, that the disability experience has been somewhat unfavorable since 1983 as compared to the estimates, and there is a need at some time in the not too distant future to have a small reallocation back from OASI to DI. You will recall that, in 1983, there was a large reallocation the other way. In fact, the DI allocation was reduced by 45 percent, and it appears that that was somewhat too much, and a reallocation is necessary.

The favorable short-range experience differs significantly from the long-range actuarial balance in the successive trustees reports. These show larger and larger actuarial balances in part due to the aforementioned disability experience. Nonetheless, the program is still in close actuarial balance, although I believe that the method of measuring that significant element is in need of thorough reexamination and improvement. I would hope that the upcoming Advi-

sory Council on Social Security to be named after next January will set this as one of its major responsibilities.

There are various methods of funding the OASDI program. The present funding basis is not, as is often erroneously said, pay-as-you-go financing. Rather, very large fund balances will be built up during the next four decades. The fund ratio, which is the fund balance expressed as a percentage of the next year's outgo, peaks at 531 percent in 2015 when it is estimated at \$6.8 trillion in current dollars or \$2.3 trillion in 1988 dollars, truly horrendous sums. After 2015, the trust fund continues to grow in terms of current dollars, but eventually turns around and declines and would be exhausted in, according to the intermediate estimate, the year 2048.

At that point, if the benefit structure is maintained, there would be a need for a higher tax rate ultimately than is scheduled in present law. I give some figures on that in my prepared testimony.

I also would like to point out, unlike what is often said, that the building up of this fund, according to the recommendations of the National Commission on Social Security Reform, was not intended to fund the cost for the baby boomers. Some people say that you build up the fund for the baby boomers, and then you spend it for them, but they don't answer the question, "What happens next?". What happens next is, if the fund is exhausted, you need much higher tax rates. And, in fact, although the baby boomers in number create a peak, the actual outgo of the system is not going to drop sharply after the baby boomers pass from the scene.

Actuarially, I believe there are only two feasible ways to finance a social security program. One is pay-as-you-go, which means you have a small fund, and you otherwise keep income closely in balance with outgo. The other way is what is called a partial-reserve procedure, under which you build up a fund and then maintain it. If you were to do this now for OASDI, it is full circle back to where we were in 1935, because that is the basis under which the original Social Security Act was funded.

To build up a fund and maintain it means that you would have to have higher tax rates after about the year 2030 than under the present schedule, so as to stop the fund from decreasing. However, these higher tax rates are no higher than what would eventually be necessary when the fund would be exhausted some 20 years later.

I believe that a pay-as-you-go basis is the best way to proceed for reasons that I will get into in a moment. The tax schedule to accomplish this result is shown in detail in my testimony. According to my proposal, the OASDI tax rate for 1989 would be reduced from the 6.06 percent rate now scheduled, which went into effect this year, and be rolled back to the rate that prevailed in 1984 to 1987, and then would be held at that level through 1994. This would, of course, eliminate the increased rate scheduled for 1990 under present law.

After 1994, a further decrease in the rate could be instituted for a number of years, up until about the year 2015. In this period, up to 1994, the trust fund would continue to grow and would reach a level of 1 year's outgo, which I believe is sufficient. After you reach the year 2015, when the baby boomers are coming on to retirement,

the tax rate would need to be increased, and again in 2020 and 2025.

These proposed tax rates would be lower than presently scheduled in 1989 to 2019, higher in 2020-48, and slightly lower thereafter—as a result of having available the interest earnings on the accumulated fund of one year's outgo as compared with the present law where there is no longer a fund after the year 2048.

Now, if some object to the higher rates for 2020 to 2048, I would point out they are not as high as what would result under present law after 2048 if the benefit structure were left unchanged.

Why is the present method of funding undesirable? That method is to build up a big fund and then use it up. I think that it is illogical from an actuarial standpoint—under present law, you would have to have a higher tax rate ultimately than is now scheduled in the law.

From a budget standpoint, I believe that the easy availability of funds that can be borrowed by the General Treasury for general purposes in the next two decades might give false impressions to people about the budget situation of the country. It is true, as the previous witness said that, if you cut the tax rate back next year, as I suggest, and then keep it low, thereafter the budget deficit as shown by including OASDI is greater. But, I think that it is a more realistic picture of the general budget to have OASDI included. After all, over the decades, OASDI has had a balanced budget; it is the rest of the Government operations that has been unbalanced.

Furthermore, if under present law, when you start disinvesting this huge trust fund, beginning in maybe 2025 or 2030, there would, as Mr. Chandler pointed out, be great fiscal problems. How do you pay off these bonds? You have to have much higher taxes or else sell the bonds to somebody else. There would be terrific problems for the Secretary of the Treasury to disinvest this huge fund.

From a Social Security standpoint, building up a large fund would create irresistible pressures for benefit liberalization in the near future. We are already hearing some people saying, "Look how big that fund is, let's use it. We can use a little here and there, and it won't hurt." Obviously, if you have benefit liberalizations now, this will make the financial problems that much worse later on when the higher cost due to the baby boomers subsequently comes along.

If the financing basis of the OASDI program is restructured along the lines that I have proposed, so that its funding is on a pay-as-you-go basis, not only would OASDI be on a more sound and desirable basis, but the budget picture would be clearer and more realistic. The short-range deficit situation insofar as the budget is concerned would be portrayed vividly and honestly.

Also, there would not arise the onerous situation that the Secretary of the Treasury will have in disinvesting the fund some 35 or 40 years from now. All in all, a revision of the funding basis of the OASDI program so that it is on a true pay-as-you-go basis is desirable from every viewpoint, not only as to the program itself, but also as to budgetary and debt-management procedures.

Thank you, Mr. Chairman.

Chairman JACOBS. Thank you.

[The statement of Robert J. Myers follows:]

STATEMENT BY ROBERT J. MYERS PRESENTED TO THE SUBCOMMITTEE ON SOCIAL SECURITY,
COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES,
ON SOCIAL SECURITY FINANCING, MAY 10, 1988

Mr. Chairman and Members of the Subcommittee: My name is Robert J. Myers. I served in various actuarial capacities with the Social Security Administration and its predecessor agencies during 1934-70, being Chief Actuary for the last 23 of those years. In 1981-82, I was Deputy Commissioner of Social Security, and in 1982-83, I was Executive Director of the National Commission on Social Security Reform.

This testimony will deal with the present financial status of the Social Security program -- Old-Age, Survivors, and Disability Insurance (OASDI) -- and with the problems that I see as being present with the manner in which OASDI is being financed and funded under present law. Such problems relate both to the program itself and to the general budgetary situation of the Federal Government.

My testimony will use, as the basis for discussion of future financing trends and situations, the data from the 1988 OASDI Trustees Report, as much as possible.

Present Financial Status of OASDI

The OASDI system is currently in excellent financial health. The assets of the OASDI Trust Funds at the end of 1987 amounted to almost \$69 billion. This, as shown by Tables 1 and 2, was \$48 billion higher than was estimated for that date in the pessimistic (or Alternative III) estimate made when the 1983 Amendments were enacted -- on which estimate the short-range financing (for the 1980s) was founded in the legislation. Such excess of actual over estimated fund balance was as much as \$35 billion for the intermediate (or Alternative II-B) estimate.

However, when the experience for the OASI and DI Trust Funds is examined separately, a small problem appears. The actual DI Trust Fund balances have been decreasing since 1983, even though both estimates predicted a more or less level trend. This has resulted from unfavorable disability experience as compared with the estimates -- both somewhat more awards and somewhat fewer terminations. It would seem desirable to reallocate once again the OASDI tax rate between OASI and DI, so as to give the latter a little more. It will be recalled that the 1983 Amendments reduced the DI allocation by 47% relatively for 1988-87, by 44% for 1988-89, and by 45% for 1990-99. Evidently, this was somewhat too much of a decrease, and a portion of it should be restored, beginning in 1989.

The favorable short-range experience differs significantly from the estimates of the long-range actuarial balance in the successive Trustees Reports. These have shown larger and larger actuarial lacks of balance -- in part, due to the aforementioned unfavorable disability experience. Nonetheless, the program is still in "close actuarial balance", although I believe that the method of measuring that significant element is in need of thorough re-examination and improvement.

Various Methods of Funding OASDI

Next, I will briefly discuss the advantages and disadvantages of current-cost funding as against advance funding (either full-reserve or partial-reserve) for benefit systems with rising relative costs over the years, when considered as percentages of taxable payroll. The discussion thus applies to systems like OASDI. By current-cost, or pay-as-you-go, financing is meant that, on the whole, income will approximately equal outgo each year. Under this approach, a fund would be built up and maintained that would be approximately 6 - 12 months of outgo. Such a contingency reserve would be utilized to finance the system when business recessions temporarily reduce tax contribution income. It would then be built up again during times of economic recovery.

Certain matters in connection with funding relating to plans of individual employers (especially non-governmental ones) are not applicable to national social insurance systems -- for example, the possibility of going out of business or of not having new entrants. The following discussion will relate only to the OASDI system.

The advantage of full-reserve funding -- and, similarly, to a considerable extent, of partial-reserve funding -- is simply that thereby the contribution rate ultimately will be lower than it would be under current-cost funding. This occurs because the interest on the assets accumulated from the excess of income over outgo in the early years of operation is available to meet the outgo. Assuming that the assets of the OASDI Trust Funds are invested in government-debt obligations (as seems to be the only proper procedure), the resulting interest income is "valid". If these obligations were not held by OASDI, they would have been held by the general public, and the same interest on them would have been paid.

It could be argued that the higher contribution rates in the early years, and the lower ones later, under full- or partial-reserve financing would result in greater intergenerational equity. This is so because the initial covered population, especially those near retirement, receive "windfalls" (as measured by considering the value of their benefits as against the contributions paid by them or on their behalf) as compared with the situation for young new entrants. Accordingly, a level contribution rate (or, even, a higher rate in the early years than later) -- as might be provided under a full- or partial-reserve funding approach -- would alleviate the situation.

The disadvantages advanced against full- or partial-reserve funding are more of a "political" nature than of a theoretical, actuarial nature. One problem would result from the huge amounts of investments involved, which could absorb a very large portion of the National Debt (or even all of it) and thus not leave sufficient for the general investment market. Another problem might be that the ready availability of large amounts of money that could easily be borrowed by the General Fund of the Treasury would encourage excessive governmental spending.

Yet another problem is that the presence of a very large fund balance could create politically irresistible demands for greatly liberalized benefits on the grounds that "all that money is there". The difficulty, then, if such liberalization did occur, and the fund balance were drawn down, would be that the OASDI costs in future years would be greatly increased over those under present law -- and the long-range financing problems would become greater.

Actual Funding Basis of the OASDI Program

Next, I will take up the subject of how OASDI has been funded over the years. The original system (1935 Act) was funded on a partial-reserve basis -- and not on a fully-funded basis, as sometimes alleged. The 1939 Act, which expanded the program to include auxiliary and survivor benefits, was also funded on a partial-reserve basis -- and did not institute current-cost funding, as is often erroneously stated. However, the system was then funded at a lower relative level than under the 1935 Act.

During the 1960s and 1970s, the emerging experience of OASDI was such that the funding was actually on a more or less current-cost basis. However, until 1972, the funding basis as to the estimated future experience was still on a "partial-reserve" basis. The 1972 Act introduced the concept of current-cost funding over the long range, but the 1977 Act (and the 1983 Act as well) did not follow this principle.

Under current law, the funding basis of OASDI is not -- as is often erroneously said -- pay-as-you-go financing. Rather, very large fund balances will be built up during the next four decades under the intermediate estimate. The fund ratio -- which is the fund balance expressed as a percentage of the next year's outgo -- peaks at 531% in 2015, when it is estimated at \$6.8 trillion in current dollars, or \$2.3 trillion in 1988 dollars. After 2015, the fund balance continues to grow in terms of current dollars, reaching a peak of about \$12 trillion shortly after 2030. Even under the pessimistic assumptions, the fund balance in 2015 would be \$3.4 trillion in current dollars, or \$0.9 trillion in 1988 dollars.

After the end of the build-up period, the assets of the trust funds will be drawn upon, and they will be exhausted shortly before 2050. At that time -- if the benefit provisions are left unchanged -- additional financing, higher payroll tax rates, will be necessary. These increases in the tax rate would, on the basis of the intermediate-cost estimate, have to be 1.8% for both the employer and the employee over the rate now scheduled for 1990 and after -- not an unmanageable rise.

No legislative intent has seemed to have been present, or expressed, to change over to this funding basis from the current-cost approach adopted in 1972 and supported over the subsequent years by the Board of Trustees.

How the Present Funding Basis for OASDI Came About

One might well ask why the National Commission on Social Security Reform, when it developed recommendations that led to the enactment of the 1983 Amendments, did not consider the manner in which the long-range financing of the OASDI program would unfold. While the members of the National Commission were aware of this situation, there was the much more pressing matter of developing a solution to the short-range financing problem -- through the 1980s. The OASDI portion of the OASDI Trust Funds was estimated to run out of money in mid-1983, so that -- if no action were taken -- benefit checks would not go out on time. Accordingly, the National Commission devoted its major efforts to the financing problems of the 1980s, although at the same time attempting to assure that, on the average, the program would be financed adequately over the next 75 years.

The National Commission thus developed its recommendations by assuring, as much as possible, that the year-by-year financing in the 1980s would be adequate and that -- over the long range and on the average -- sufficient financing would be provided. As we know, the use of averages can, at times, be deceptive. It certainly is the case in this situation, as compared with looking at the year-by-year development of the trust-fund balances over the long run. I think that it is fair to say that the National Commission knew that, once the short-range problems were definitely solved -- as they certainly have been -- then a closer look should be given to the long-range situation. This definitely should be a major function of the statutory Advisory Council on Social Security that is to be named after next January.

Currently, there is a widespread myth about the financing of the Social Security program as provided in the 1983 Amendments. Specifically, many believe that the intention was to "prefund" by saving enough money over the next 10 to 20 years to pay for benefits to the huge generation of post-World War II baby boomers that will retire 25 to 40 years from now.

This was by no means the thinking of the National Commission when it made its recommendations, or the intention of Congress when it enacted the legislation -- as indicated previously. Accordingly, the building up of a huge fund that would peak in the midst of the baby boomers' retirement period was merely a coincidence.

What Should Be Done About the Funding Basis of OASDI?

I believe that OASDI should be financed on close to a current-cost basis. Income should, on the whole, slightly exceed outgo each year, in order to build up a fund which is about equal to one year's outgo -- and certainly no more. This should be accomplished by changing the future tax-rate schedule so as to more nearly match the trend of outgo. In the near future, the tax rate should be a little higher than this, so as to build up the fund balance to the desired goal of one year's outgo.

My proposed tax schedule to accomplish this result, developed on the basis of the intermediate-cost estimate, is shown in Table 3, along with the present one. The tax rate for 1989 would be reduced from the 6.06% rate now scheduled, which went into effect this year, and would be rolled back to the 5.7% rate that prevailed in 1984-87, and then would be held at that level through 1994 (thus eliminating the increase to 6.2% scheduled for 1990). Thereafter, the rate should be decreased by 0.6% in 1995, after an adequate fund balance had been accumulated. The rate would need to be increased in 2015, and then again in 2020 and 2025.

These proposed tax rates would be lower than presently scheduled in 1989-2019, higher in 2020-48, and slightly lower thereafter (as a result of having available the interest earnings on the trust-fund balance that has been accumulated -- as against none at that time under present law). If some object to the higher rates for 2020-48, note that they are not as high as would ultimately result under present law if the benefit structure were left unchanged.

Under my proposal, the trust-fund balance would slowly, but steadily, build up over the years. It would reach about \$400 billion in 2015 (in 1988 dollars), as compared with a relative peak then of \$2.3 trillion under present law -- and as compared with \$69 billion at the end of 1987. Then, in 2048, the fund balance under my proposal would be about \$900 billion, as against bankruptcy under present law. The "roller-coaster" effect under present law would be replaced by slow, but steady growth.

A good way of looking at the situation under both present law and my proposal is to consider the fund ratios for OASDI. Under present law, the ratio grows from 41% at the beginning of 1988 to a peak of 531% in 2015 and then falls to zero 34 years later. On the other hand, under my proposal, the ratio would slowly increase to about 100% before the turn of the century and would remain at that level thereafter. Once again, the stability of my proposal is evident.

Some might argue that future experience may not follow the intermediate-cost estimate, and then what of my proposal and its revised tax schedule? The answer is that the tax schedule should be reviewed from time to time as the experience unfolds, and as new estimates of the future experience are prepared. Congress could then legislate different scheduled tax rates or changes in the benefit provisions. But this would also have to be done if the present tax schedule and funding method were to be continued, and is done, in any case, in the annual reports of the Board of Trustees.

A procedure that might be used in lieu of revising the tax schedule in order to accomplish the desired result of pay-as-you-go financing would be to have automatic adjustment of the tax rate so as to maintain approximately the desired fund ratio. A description of such a procedure was contained in a staff memorandum furnished to the National Commission on Social Security Reform ("Methods to Assure Adequate Financing of OASDI Program Through Loans or Through Automatic Adjustment of Either Benefits or Taxes", Memorandum No. 63 (Revised), November 22, 1982).

Relationship Between OASDI Program and National Budget

The manner in which, under present law, the OASDI Trust Funds first build up huge amounts in the next four decades and then decrease over the next two decades until being exhausted would have significant, deleterious effects on public-debt management and on Budget operations.

The relationship between the operations of the OASDI Trust Funds and the Budget is frequently misunderstood by the general public. Beginning in fiscal year 1986, the operations of the trust funds have been out of the Unified Budget, so that any excess of income over outgo of the trust funds does not reduce the Budget deficit. However, anomalously, it was provided that these trust-fund excesses of income over outgo are counted to meet the Gramm-Rudman-Hollings targets for Budget-deficit reduction. The result is thus virtually the same as if the trust-fund operations were included in the Budget, but the imbalance is really still there, and the National Debt is increased by the amount of the trust-fund excesses of income over outgo. In other words, the result of this procedure is, in the short run, to make the targets easier to meet and thus to make the Budget deficits appear smaller than they really are.

At times, individuals propose that the Budget deficits should be reduced by making long-term permanent reductions in OASDI benefits. As indicated previously, because OASDI is not included in the Budget, such effect would not actually occur, although the Budget targets would be more readily met. Again, this seems to be a matter of deceiving ourselves. Perhaps even more importantly in this respect, because OASDI is financed on a completely self-supporting basis, any reduction in long-range benefit costs should correspondingly produce reductions in the tax rates required to support the system. The net effect of this action and reaction

is essentially counterbalancing, so that, insofar as the Budget is concerned (even including the Gramm-Rudman-Hollings targets), nothing would really be achieved.

If the financing basis of the OASDI program is restructured along the lines that I have proposed -- so that its funding is on a pay-as-you-go basis -- not only would OASDI be on a sound and more desirable basis, but also the Budget picture would be clearer and more realistic. The short-range deficit situation insofar as the Budget is concerned would be portrayed vividly and honestly. Also, there would not arise the onerous situation that, under present law, could be placed on the Secretary of the Treasury for several decades following about 2025. Such situation is that, in the absence of huge increases in general taxes, the Secretary would have to sell huge amounts of government-debt obligations each year to the general public, because the assets of the OASDI Trust Funds would then have to be liquidated to meet the excesses of benefit outgo over tax income.

All in all, a revision of the funding basis of the OASDI program so that it is on a true pay-as-you-go basis is desirable from every viewpoint, not only as to the program itself, but also as to budgetary and debt-management procedures.

Table 1

COMPARISON OF ACTUAL OASI AND DI TRUST FUND BALANCES AT END OF YEAR
WITH THOSE ESTIMATED IN 1983
(Figures in billions)

Calendar Year	Actual Net Balance ^{a/}	Estimated Net Balance ^{a/}		Excess of Actual Over Estimated Balance	
		Alt. II-B	Alt. III	Alt. II-B	Alt. III
OASI Trust Fund					
1983	\$2.2	\$3.8	\$3.1	-\$1.6	-\$0.9
1984	9.6	6.1	2.1	3.5	7.5
1985	20.1	11.7	5.3	8.4	14.8
1986	39.1	16.4	8.1	22.7	31.0
1987	62.1	22.6	10.6	39.5	51.5
DI Trust Fund					
1983	\$10.3	\$11.1	\$11.1	-\$0.8	-\$0.8
1984	9.1	10.5	10.1	-1.4	-1.0
1985	8.8	10.3	9.7	-1.5	-.9
1986	7.8	10.4	9.8	-2.6	-2.0
1987	6.7	11.2	10.2	-4.5	-3.5

^{a/} The net balance of the OASI Trust Fund is the total assets, minus the outstanding loans (if any) from the DI and HI Trust Funds. Similarly, the net balance of the DI Trust Fund is the total assets, plus the outstanding loans (if any) to the OASI Trust Fund.

Source: Estimated data are from "Actuarial Cost Estimates of the Effects of Public Law 98-21 on the Old-Age, Survivors, and Disability Insurance and Hospital Insurance Programs, Committee on Ways and Means, House of Representatives, WMCP:98-13, September 8, 1983.

Table 2

COMPARISON OF ACTUAL OASDI AND HI TRUST FUND BALANCES AT END OF YEAR
WITH THOSE ESTIMATED IN 1983

(Figures in billions)

Calendar Year	Actual Net Balance ^{a/}	Estimated Net Balance ^{a/}		Excess of Actual Over Estimated Balance	
		Alt. II-B	Alt. III	Alt. II-B	Alt. III
OASDI Trust Funds					
1983	\$12.5	\$14.9	\$14.2	-\$2.4	-\$1.7
1984	18.7	16.6	12.2	2.1	6.5
1985	28.9	22.0	15.0	6.9	13.9
1986	46.9	26.8	17.9	20.1	29.0
1987	68.8	33.8	20.8	35.0	48.0
HI Trust Fund					
1983	\$25.3	\$24.1	\$24.0	\$1.2	\$1.3
1984	28.1	23.2	22.1	4.9	6.0
1985	31.1	22.5	19.2	8.6	11.9
1986	40.0	22.8	15.8	17.2	24.2
1987	53.7	20.5	8.0	33.2	45.7
OASDI and HI Trust Funds					
1983	\$37.8	\$39.0	\$38.2	-\$1.2	-\$0.4
1984	46.8	39.8	34.3	7.0	12.5
1985	60.0	44.5	34.2	15.5	25.8
1986	86.9	49.6	33.7	37.3	53.2
1987	122.5	54.3	28.8	68.2	93.7

^{a/} The net balance of the OASDI Trust Funds is their total assets, minus the outstanding loans (if any) from the HI Trust Funds to the OASI Trust Fund. The net balance of the HI Trust Fund is its total assets, plus the outstanding loans (if any) to the OASI Trust Fund.

Source: See Table 1.

Table 3

PRESENT AND PROPOSED SOCIAL SECURITY TAX RATES^{a/}
FOR EMPLOYERS AND EMPLOYEES (each)

Period	Present Law	Proposal	Difference
1984-87	5.7%	5.7%	--
1988	6.06	6.06	--
1989	6.06	5.7	-.36%
1990-94	6.2	5.7	-.5
1995-2014	6.2	5.1	-1.1
2015-19	6.2	6.0	-.2
2020-24	6.2	6.8	+.6
2025-48	6.2 ^{b/}	7.6	+1.4
2049 and after	8.0	7.7	-.3

^{a/} These rates do not include the tax for the Hospital Insurance portion of Medicare -- currently, 1.45% (and so scheduled for all future years). Also, in 1984, the employee rate was reduced by a tax credit of 0.3%.

^{b/} Rate necessary to finance scheduled benefits.

Chairman JACOBS. Mrs. Munnell.

**STATEMENT OF ALICIA H. MUNNELL, SENIOR VICE PRESIDENT
AND DIRECTOR OF RESEARCH, FEDERAL RESERVE BANK OF
BOSTON**

Ms. MUNNELL. Thank you for inviting me. The subject of today's hearings is an important one, and I am pleased to be able to discuss it with you.

The United States is currently faced with a unique opportunity to augment its low level of national savings by accumulating assets in the Social Security trust funds. That is, the possibility exists for Federal Government saving to increase the national saving rate. This will not happen automatically, however.

Whether or not Government saving actually occurs will depend on how the assets in the Social Security trust funds are used. If the reserves are used to finance current consumption—for example, to pay for current outlays in the rest of the budget—no real saving will occur. On the other hand, if the Government alters its spending and taxing patterns to produce surpluses at the Federal level—not just in the Social Security trust funds—the Nation will enjoy higher saving and investment.

Hence, we as a nation face an important economic choice. I would like to review some of the considerations that might enter into making that choice and discuss some of the practical problems associated with the Federal Government saving through a Social Security fund buildup.

First let us look at where the surpluses came from and how big they will be. Folklore notwithstanding, the surpluses originated with the 1977, not the 1983, amendments to the Social Security Act. We moved forward a tax rate scheduled for 2011 to 1990, so we have an increase in revenues just as we enter the 1990s, which is a period of increasing cost. As a result of the 1977 legislation, we were scheduled to have surpluses in the Social Security trust funds through 2010. The 1983 amendments greatly increased the size of the surpluses and extended their duration.

As Bob Myers just indicated, the current projection is that taxes are now projected to exceed outlay for the next 30 years. We are expected to have a buildup to produce \$2.6 trillion in 1988 dollars by the year 2018, and that money is scheduled to be drawn down to cover deficits in the Social Security finances after that time.

Now what are the economic effects of building up and drawing down Social Security trust fund reserves? Let us first assume that the buildup in the Social Security trust funds actually does result in a net positive accumulation of resources at the following level. The simplest way to think about this is to assume that the Federal budget, excluding Social Security, is brought more or less in balance, while the Social Security program is experiencing annual surpluses. In this case, the surpluses in the Social Security trust funds represent net saving by the Government and imply that a higher proportion of current output will be devoted to capital formation. If the current level of national saving is too low and if monetary and other nonfiscal policies assure full employment, surpluses at the Federal level will lead to greater long-term growth in

the supply of capital and higher future levels of output and income. And this is the key point: As a result of the surpluses, then future generations will have a relatively higher standard of living from which to contribute taxes to redeem the debt when the time comes to pay the benefits.

So far, we have just looked at the buildup in the reserves, but now we have to look at what happens when you start drawing down the reserves, currently planned for after 2018. During this time, the foregoing analysis works in reverse. After 2018, benefit commitments will exceed tax revenues so that the fund will have to use interest on the assets and eventually redeem its holdings of Government securities to provide pensions to the beneficiaries.

The redemption of Government bonds and the transfer of these funds to the public will represent dissaving by the Federal Government. This means a lower portion of current output will be devoted to capital formation.

Thus, the projected pattern of trust fund activity over the next 60 years would involve an element of forced saving between now and 2018, which, if invested productively, will increase capital accumulation, future income and consumption. After 2018, the relative value of assets in the trust funds will decline, creating dissaving at the Federal level, which will reduce the share of future output devoted to capital formation and thereby future levels of per capita output.

The important question is: What is gained by the accumulation and subsequent depletion of Social Security reserves over the next 60 years, and when do the gains occur? The exercise is primarily one of shifting the pattern of consumption from the early half of the period to the later.

Now the rationale for such a shift in consumption patterns, of course, is that the people contributing during the period of accumulation are part of the baby boom generation. This very large cohort would place a significant burden on the following generation if all its retirement benefits were financed on a pay-as-you-go basis. Because of the magnitude of this potential burden, the argument goes, this generation should pay for some of its retirement in advance by accumulating surpluses in the Social Security trust funds.

The other side of the argument, of course, is that because of its large size, the baby boom generation has already had a tough time. These people attended overcrowded schools, experienced difficulties finding jobs and found slow advancement once on the job. The mere size of this group has meant that we have had virtually no real wage growth for a decade, and has made it difficult to find affordable housing. Whether or not this generation should be the one to contribute towards its own retirement in addition to financing benefits for current retirees is an issue that should be part of the debate.

Another factor that should be considered is the wisdom of drawing down the trust fund reserves once they are accumulated. This goes back to a point Bob Myers made. The discussion that surrounding this part of the proposal seems to imply we that are facing a temporary blip in the cost of Social Security as the baby boom passes through—a rat being digested by a snake. In other words, the implication is that the number of beneficiaries per hun-

dred workers will go from its current level, 30 beneficiaries per hundred workers, up to 55 and then back down. This is not the case; we are facing a permanent increase in the ratio of beneficiaries to workers. We are going to go from the current level of 30 beneficiaries up to 55, and we are going to stay there.

The reason for this increase is that we expect the fertility rate, which has been reduced by nearly half since 1960, to remain around its present level. Hence, if the decision is made to pre-fund some Social Security benefits, it may make more sense to build up the fund and keep it as a permanent source of partial funding rather than to draw it down. This would require a tax increase around the year 2018, and this issue should also be part of the debate.

But regardless of whether the fund is eventually drawn down or not, accumulating surpluses in the Social Security program may be the most effective way of raising the nation's saving rate over the next 30 years. Accomplishing this goal, however, involves surmounting some practical problems. The most crucial, and again I am alluding to something Bob Myers brought up, is making sure that trust fund surpluses are not simply offset by deficits in the rest of the Federal budget. If payroll tax revenues earmarked to pay future retirement and disability benefits are loaned to the Treasury and the Treasury uses this money to cover current outlays in the general fund, then the surpluses will have contributed nothing to overall saving and capital accumulation. The full burden of supporting the beneficiaries will come from the taxpayers in the second part of the period, just as if the system had been financed on a pay-as-you-go basis all along.

The evidence from other countries that have tried to fund their public pension systems is not entirely encouraging. Canada, Japan, and Sweden in particular have accumulated large public pension trust reserves in order to augment private savings, but from my reading, only Sweden appears to have been successful, and that country has a much more controlled and planned economy than we have. I mention the international evidence not to argue that Federal Government saving is impossible, but only that it is difficult, and if we choose to proceed along this path, it appears we could learn quite a bit from both the successes and the failures of other countries.

What I would like to emphasize is that we have time to look at what has happened in other countries and to think about this issue. We do not have to determine today the course of fiscal policy for the next 75 years or even the next 25 years. Regardless of what we decide to do for the long run, it seems our short-run agenda is set. Whether or not we ultimately decide to continue with a plan to pre-fund the Social Security program, prudence tells us to continue building up trust fund assets at least until we have an adequate contingency reserve. My calculations indicate that a reserve equal to 150 percent of annual outlays would be required to weather the kind of back-to-back recessions that we experienced during the 1970s. This level of contingency fund will not be reached until 1995. Long-term funding decisions can be postponed until we near that time.

The desired path of the non-Social Security portion of the budget is equally clear. Fiscal responsibility requires that we bring our taxes and spending activities more in line. Continuing deficits produce a large debt burden for our children and make our own welfare dependent on the goodwill of foreign governments. Hence, at the same time that we are accumulating a contingency reserve in the Social Security funds, we should be reducing the deficits in the rest of the budget.

We should also be spending that time debating whether we want to try to increase our national saving rate by continuing to accumulate surpluses in the Social Security trust funds. It is a very complicated task. An important factor to keep in mind while the debate takes place, however, is that the Social Security program itself will function perfectly well under either scenario. If a fund is built up, current tax rates should be adequate to finance benefits for the next 60 years. If OASDI reserves are not accumulated during the period from now until 2018, OASDI taxes will have to be raised at that time to cover the deficits on a current cost basis.

But it is important to look also at the magnitude of the potential tax increase. It is not as if the system were going to crumble. We would have to have a tax increase of between 1 and 2 percent of taxable payrolls each for the employee and the employer. This is a significant burden, but it is manageable. In short, we are not faced with another Social Security crisis here, as some might lead you to believe, but rather with an opportunity to increase national saving and investment.

Thank you.

[The statement of Alicia H. Munnell follows:]

STATEMENT OF ALICIA H. MUNNELL*

*Senior Vice President and Director of Research, Federal Reserve Bank of Boston. The views expressed are solely those of the author and do not necessarily reflect the views of the Federal Reserve Bank of Boston or the Federal Reserve System.

Mr. Chairman and members of the Committee, thank you for inviting me. The subject of today's hearings is an important one and I am pleased to be able to discuss it with you.

The United States is currently faced with a unique opportunity to augment its low level of national saving by accumulating assets in the Social Security trust funds. That is, the possibility exists for federal government saving to increase the national saving rate. This will not happen automatically, however.

Whether or not government saving actually occurs will depend on how the assets in the Social Security trust funds are used. If the reserves are used to finance current consumption—for example, to pay for current outlays in the rest of the budget—no real saving will occur. On the other hand, if the government alters its spending and taxing patterns to produce surpluses at the federal level—not just in the Social Security trust funds—the nation will enjoy higher saving and investment.

Hence, we as a nation face an important economic choice. I would like to review some of the considerations that might enter into making that choice and discuss some of the practical problems associated with the federal government saving through a Social Security fund buildup.

I. Where Did the Surpluses Come From and How Big Will They Be?

How did the Social Security system, which for the past three decades has been financed more or less on a pay-as-you-go basis, become slated to accumulate large surpluses? Folklore notwithstanding, the surpluses originated with the 1977, not the 1983, amendments to the Social Security Act. As you remember, in order to strengthen the financing of the program, this legislation extensively revised both the benefit and the revenue provisions. Most of the additional revenue for the long run came from increasing a rate hike already planned for 2011 and making it effective in 1990. This meant that the rate hike, which was originally scheduled to coincide with rising benefit costs as the baby boom retired, would take effect while, for demographic reasons, costs were declining as a percent of payrolls. The combination of increased revenues and lower costs was projected to produce annual surpluses in the Social Security program through the year 2010. Even so, the 1977 amendments left a significant estimated deficit in the last 25 years of the 75-year projection period.

The 1983 amendments, which were designed to relieve a short-term financing crisis and to remove the long-term deficit left by the 1977 amendments, greatly increased the size of the surpluses and extended their duration. This was accomplished primarily by increasing revenues somewhat through the taxation of benefits and reducing costs significantly through a six-month freeze on the cost-of-living adjustment and the extension of the retirement age. As a result of the 1983 legislation, the intermediate cost estimates indicate that tax income to Social Security's old-age, survivors, disability insurance trust funds is projected to exceed outgo for the next 30 years. These annual surpluses will produce trust fund balances equal to roughly 30 percent of GNP, or \$2.6 trillion in 1988 dollars, by the year 2018. These accumulated reserves are currently scheduled to be drawn down to cover annual deficits in the years between 2018 and 2048.

It is important to note that the proposal in question now is one of building up and then drawing down reserves, so that the economy will more or less be in the same position in 2048 regardless of whether or not we pursue a policy of building a large reserve. Although I will discuss another option later, the current issue under consideration, then, is how individuals and the economy will be affected during the intervening period between now and 2048. This is not a trivial question, however, since the intervening 60 years is a very long time.

II. Economic Effects of Building Up and Drawing Down Reserves

In assessing the potential impact of the scheduled accumulation and subsequent depletion of trust fund reserves, let us first assume that the buildup in the Social Security trust funds actually does result in a net positive accumulation of resources at the federal level. The simplest way of thinking about this is to assume that the federal budget, exclusive of Social Security, is brought more or less in balance, while the Social Security

program is experiencing annual surpluses. In this case, the surpluses in the Social Security trust funds represent net saving by the government and imply that a higher proportion of current output will be devoted to capital formation. If the current level of national saving is too low and if monetary and other non-fiscal policies assure full employment, surpluses at the federal level will lead to greater long-term growth in the supply of capital and higher future levels of output and income. As a result of the surpluses, then, future generations will have a relatively higher standard of living from which to contribute taxes to redeem the debt when the time comes to pay benefits.

The discussion so far has focused on the accumulation of reserves between now and 2018, but has not referred to the drawdown that is slated to occur later in the forecast period. During this time, the foregoing analysis works in reverse. After 2018, benefit commitments will exceed tax revenues, so that the Trustees of the fund will have to use interest on the assets and eventually redeem their holdings of government securities in order to provide pensions to the beneficiaries. The redemption of the government bonds and the transfer of these funds to the public will represent dissaving by the federal government. This means that a lower portion of current output will be devoted to capital formation.

Thus, the projected pattern of trust fund activity over the next 75 years would involve an element of forced saving between now and 2018, which, if invested productively, will increase capital accumulation, future income and consumption. After 2018, the relative value of assets in the trust funds will decline, creating dissaving at the federal level, which will reduce the share of future output devoted to capital formation and thereby future levels of per capita output.

The important question is: what is gained by the accumulation and subsequent depletion of Social Security reserves over the next 75 years, and when do the gains occur? The exercise is primarily one of shifting the pattern of consumption from the early half of the period to the later. That is, people living during the period of accumulation would have lower per capita consumption than they would have otherwise. During the period of drawdown, on the other hand, consumption will receive a boost from two sources. First, the increased saving and capital accumulation from the buildup of the trust funds will start to pay off in the form of higher levels of national output and consumption. Second, the drop in savings brought on by the drawing down of the trust fund assets could create a consumption binge similar to the one we have just experienced.

III. The Rationale for a Large Reserve

The rationale for such a shift in consumption patterns, of course, is that the people contributing during the period of accumulation are part of the baby boom generation. This very large cohort would place a significant burden on the following generation if all its retirement benefits were financed on a pay-as-you-go basis. Because of the magnitude of this potential burden, the argument goes, this generation should pay for some of its retirement in advance by accumulating surpluses in the Social Security trust funds. The other side of the argument, of course, is that because of its large size, the baby boom generation has had a difficult time. These people attended overcrowded schools, faced severe competition getting into college, experienced difficulties finding jobs, and found slow advancement once on the job. The mere size of this group has contributed to the virtual freezing of real wage growth for a decade and has made it difficult to find affordable housing. Whether or not this generation should be the one to contribute towards its own retirement in addition to financing benefits for current retirees is an issue that should be part of the debate.

Another factor that should be considered is the wisdom of drawing down the trust fund reserves once they are accumulated. The discussion surrounding this part of the proposal seems to imply that we are facing a temporary blip in the cost of Social Security as the baby boom generation passes through—a rat being digested by a snake. In other words, the implication is that the number of beneficiaries per hundred workers will go from its current level of 30 up to 55 and then back down. This is not the case; we are facing a permanent increase in the ratio of beneficiaries to workers, because we expect the fertility rate, which has been reduced by nearly half since 1960, to remain around its present level. The number of beneficiaries per hundred workers will rise from the present level to 55 and remain there, and the pay-as-you-go costs of the Social Security program will increase proportionately. Hence, if the decision is made to pre-fund some Social

Security benefits, it may make more sense to build up the fund and keep it as a permanent source of partial funding rather than draw it down. This would require a tax increase around the year 2018. This issue should also enter the debate.

IV. Difficulties with Saving through Social Security

Whether the fund is eventually drawn down or not, accumulating surpluses in the Social Security program may be the most effective way of raising the nation's saving rate over the next 30 years. Accomplishing such a goal, however, involves surmounting some practical problems.

The most crucial is making sure that trust fund surpluses are not simply offset by deficits in the rest of the federal budget. If payroll tax revenues earmarked to pay future retirement and disability benefits are loaned to the Treasury and the Treasury uses these monies to cover current outlays in the general fund, then the surpluses will have contributed nothing to overall saving and capital accumulation. The full burden of supporting the beneficiaries will come from the taxpayers in the second half of the period--just as if the system had been financed on a pay-as-you-go basis all along. The only effect of accumulating Social Security surpluses would be to alter the composition of federal revenues over time. General government expenditures during the first half of the period would be financed by the relatively regressive payroll tax rather than the more progressive income tax, and future benefit payments would be financed in part by general revenues.

The evidence from other countries that have tried to fund their public pension systems is not entirely encouraging. Canada, Japan and Sweden in particular have accumulated large public pension trust reserves in order to augment private savings, but only Sweden appears to have been successful. Since the inception of the Swedish program in 1959, large annual surpluses have usually swamped the relatively small deficits in the general accounts. (The exception is the period 1979 to 1986, when a weak economy led to overall negative numbers.) By 1986, the fund had amassed assets equal to 46 percent of GDP and accounted for over one-third of the stock of assets in organized financial markets. Thus, the Swedish public pension plan appears to have contributed to national saving.

The Japanese experience seems to have been quite different. Japan developed a partially funded public pension system in 1954, and by 1986 total assets in the trust funds accounted for 17 percent of GDP. The key difference between Sweden and Japan, however, is that, for most of this time, Japan has run deficits in the overall federal budget. That is, the deficits in the non-Social-Security portion of the budget more than offset the surpluses in the pension system.

The Canada Pension Plan is also a partially funded system, which has accumulated assets equal to 6 percent of GDP. The original idea was that the funds would be lent to the provinces for use as investment capital. The Canada Pension Plan had the potential to increase substantially the flow of private investment capital out of provincial securities and into the private capital market, while supporting an increased level of capital investment. As it has turned out, private capital investment has not increased as a result of the Canada Pension Plan surpluses, and provincial governments have allocated a large share of these surpluses to current consumption expenditures. Hence, neither the Japanese nor the Canadian funding efforts appear to have augmented national saving.

This brief international excursion has not been to argue that federal government saving is impossible, but only that it is difficult. If we choose to proceed along this path, it appears that we could learn quite a bit from both the successes and failures of other countries.

V. Implications for Immediate Action

We have time to undertake such explorations. We do not have to determine today the course of fiscal policy for the next 75 years or even 25 years. Regardless of what we decide to do for the long run, our short-run agenda is already set. Whether or not we decide ultimately to continue with a plan to pre-fund the Social Security program, prudence tells us to continue building up trust fund assets at least until we have an adequate contingency reserve. My calculations indicate that a reserve equal to 150 percent of annual outlays would be required to weather the kind of back-to-back recessions that we experienced during the 1970s. The most recent projections by the Social

Security Administration indicate that this level of contingency fund will not be reached until 1995. Long-run funding decisions can be postponed until we near that time.

The desired path for the non-Social Security portion of the budget is equally clear. Fiscal responsibility demands that we bring our tax and spending activities more in line. Continued deficits produce a large debt burden for our children and make our own welfare dependent on the goodwill of foreign governments. Hence, at the same time that we are accumulating a contingency reserve in the Social Security trust funds, we should be reducing the deficits in the rest of the budget.

We should also be debating whether we want to try to increase our national saving rate by continuing to accumulate surpluses in the Social Security trust funds. It is a complicated task. An important factor to keep in mind while the debate takes place, however, is that the Social Security program will function perfectly well under either scenario. If a fund is built up, current tax rates should be adequate to finance benefits for the next 60 years. If OASDI reserves are not accumulated during the period from now to 2018, then OASDI taxes will have to be raised in 2018 to finance annual deficits on a current cost basis. It is important to note, however, that the rate increase required would be between 1 and 2 percent each for the employer and the employee.

In short, we are not faced with another Social Security crisis, but rather with an opportunity to increase national saving and investment.

Chairman JACOBS. Mr. Aaron.

STATEMENT OF HENRY J. AARON, SENIOR FELLOW, THE BROOKINGS INSTITUTION, AND PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND

Mr. AARON. I have submitted a statement which I ask to be included in the record. I am not going to read it all because I would like to touch on issues that have come up and remarks others have made. In tune with the times, I should, perhaps, identify myself. I am a Gemini. I moved to Washington D.C. in the 1960's. I must say I am glad to be here for the final flowering of the age of Aquarius.

I would like to comment on both the methodology of the projections that were just issued by the actuaries and on the substance that they contain. The United States is one of a very few countries in the world that publishes long-run actuarial projections stretching 75 years into the future. A lot of countries don't publish any at all and few publish projections that don't look nearly so far in advance. So I think we ought to pause a moment and congratulate successive governments for adhering to a uniquely conservative and cautious practice with respect to the fundamental retirement program.

This year's reports on Social Security are highly reassuring, as far as the old age survivors and disability insurance program are concerned. They document the adequacy of legislated taxes to pay for benefits promised under current law as Mr. Myers observed. The system remains within close actuarial balance. By way of definition close actuarial balance means that benefits do not exceed revenues or revenues do not fall short of projected benefits over 75 years by more than 5 percent or exceed them by more than 5 percent.

Projections for Medicare are far less favorable and although I go into that problem in my statement, I am going to leave those issues aside in my oral remarks so that I can pay more attention to the pension programs. First, let me turn to the projections themselves, the issues of liquidity and solvency of the system. In contrast to Mr. Myers, my reading of the experience of the mid 1970's and 1980's is that prudent management of the Social Security system, to say nothing of overall budget policy requires that the pay roll tax increases now scheduled for 1990 be allowed to go into effect.

The reserves that are going to result, are necessary to permit Social Security to weather what I would call a recession and a half, a major recession of the kind we experienced either in 1973-74 or that we experienced again in 1982-83. If we should have bad fortune to experience within a few years yet another recession, we would need about a 2-year reserve to be sure that Congress will not be thrown into the kind of liquidity crisis that provokes such concern on the part of the population at large and created serious problems for the Congress and the administration in the early 1980's.

A 2-year reserve isn't going to be accumulated in OASDI combined until 1987 under current projections. But as both Mr. Hartman and Ms. Munnell pointed out, Social Security reserves can play another purpose in addition to serving as a contingency re-

serve; that is, they can help add to national savings, if we assure that surpluses accumulating in the Social Security system are not used simply to offset deficits found elsewhere in the budget.

I would like to indicate what the pay off to the Nation is for building up national savings by the amount of Social Security reserves. That is the subject of the study that we are carrying out at the Brookings Institution to which Mr. Hartman referred in his testimony. If we add to national savings the amount that we will be accumulating in Social Security reserves, we will increase the amount of consumption possible for future generations of workers by more than the added costs of Social Security that will result because the baby boom is a larger population group. That is, we have arranged now with current actuarial procedures, a financing arrangement that can relieve future workers of all added burdens of Social Security pension benefits for the baby boom generation. Let me be specific about two aspects of that statement.

First, returning to what Alicia Munnell said earlier about her belief that there is a rationale for building up a reserve, but not for depleting it. Current actuarial procedures assure that that is exactly what is going to happen, contrary to the projections contained in this year's annual report. Why is that? With each passing year, if you read the detail in the actuarial reports, there is a negative number that is included for what is called the estimation period.

What does that mean? Each year we drop out a year like 1987 and pick up a year like 2062. The principal difference between those 2 years as far as these projections is concerned is that 1987 is a surplus year under current tax rates and benefit schedules and 2062 is a deficit year. That happens every year, and sooner or later those small negative items are going to throw the Social Security system out of actuarial balance and recreate a long-term deficit.

Now, Congress has followed, and successive administrations have supported a policy of recommending benefit cuts or tax increases whenever that happens. What we did in the Brookings study is assume that whenever a long-run deficit appears, Congress enacts a tax increase to sustain currently legislated benefits.

If that occurs, there will be three tax increases over the next 75 years. I will return to the degree of credence placed in these long-term projects in a moment. Those tax increases would prevent any depletion in the Social Security fund, if those surpluses are in fact invested. I repeat, successive generations of workers will bear no additional burden for Social Security pensions because their consumption will be larger as a result of increased national output that that added savings makes possible.

Let me turn to the methods and assumptions that are used in this year's report. The actuaries for the first time this year explicitly discount, that is, allow for the time value of money in calculating whether the system is within plus or minus 5 percent of projected revenues. I believe that is a step forward. The discount rate that actuaries use may be a little on the low side.

The second major innovation they made this year was to eliminate a discrepancy that previously existed between short and long-term projections. What they did was bring the long-run projections in line with the short-run projections. That tends to worsen long-

term actuarial balance, but it improves consistency of the projections and again I think that is an improvement.

The third set of changes involves future economic and demographic trends concerning fertility rates, which were reduced in the projections, assumed rates of productivity growth, which were also reduced, and assumed rates of immigration, which were increased. On balance, those three changes are about a wash as far as the system is concerned. For my own taste, I would prefer to see the productivity assumptions somewhat lower and the interest rate assumption that is used somewhat higher.

Those two changes would tend to offset one another. On balance, however, my conclusion is that the actuaries have prudently and reasonably adjusted their assumptions to bring them closer to recent U.S. experience, and I have no doubt that further changes are going to be made in the future. The actuaries, have always been properly cautious in modifying assumptions in response to what may be temporary fluctuations in the key underlying assumptions.

At present, large Social Security surpluses for the next two or three decades or even longer are virtually certain, unless we cut taxes, regardless of assumed fertility, mortality rates or interest rates. To be sure, large changes in those variables will, if they persist, have a major impact on Social Security revenues and costs in, say, the year 2060.

I would ask you in considering how fast the actuaries should respond to each new headline about what has been happening to productivity or birth rates, to throw your mind back and consider how much President Woodrow Wilson and the 64th Congress would have improved decisions in 1916, based on projections that they then made about labor productivity, health costs or the work week in America of 1988.

[The statement of Mr. Aaron follows:]

Statement
of
Henry J. Aaron*

to

Subcommittee on Social Security
Committee on Ways and Means
United States House of Representatives

May 10, 1988

Mr. Chairman:

My name is Henry Aaron. I am a senior fellow at the Brookings Institution and a professor of economics at the University of Maryland. I served as chairman of the 1979 Social Security Advisory Council and for two years as Assistant Secretary for Planning and Evaluation at the Department of Health, Education, and Welfare.

I appreciate your invitation to testify on the 1988 reports of the trustees of old age, survivors and disability insurance, hospital insurance, and supplemental medical insurance.

The United States is the only country that publishes annual projections looking as much as seventy-five years into the future. Most countries do not publish any projections, and none publishes projections looking so far into the future. The United States practice is worthy of note and of admiration, because these projections encourage legislative prudence and enable informed public debate about the cost of promised benefits and the adequacy of legislated taxes to pay for those benefits.

The publication of these projections is an annual occasion for hearings, such as these, which focus Congressional and public attention on the most important domestic federal program. Such attention is important because many Americans are worried that Social Security is inadequately financed and that sufficient funds will be unavailable when they claim their entitlements.

*Senior Fellow, the Brookings Institution and Professor of Economics, University of Maryland. The view expressed in this statement do not necessarily reflect the opinions of staff or trustees of the Brookings Institution or of staff or administration at the University of Maryland.

On all of these dimensions, the 1988 reports are reassuring as far as old age, survivors, and disability insurance are concerned. Once again, they document the adequacy of legislated taxes to pay for pension benefits promised under current law. And they embody improvements in estimating methods that should increase confidence in the sobriety of projections.

The prospects for medicare are far less favorable. Although taxes are sufficient to pay for hospital benefits promised under current law for nearly two decades, the combination of an increasing population of beneficiaries and rising hospital costs is certain to generate total outlays far in excess of currently legislated taxes.

I shall divide my comments into two parts, the first devoted to the projections themselves, the second to the methods and assumptions used to reach those projections.

LIQUIDITY AND SOLVENCY

The 1988 projections of the OASDI system reaffirm that Social Security is, and will remain, awash with liquidity in the short run and remains solvent over the next seventy-five years.

Judgments vary about how large contingency reserves should be. According to some, a reserve equal to one year's benefits is sufficient, because it would enable social security to continue paying benefits without requiring a tax increase through a moderate recession. Annual surpluses will build up a trust fund to a level equal to one year's outlays by 1992.

Experience of the 1980s, in my judgment, indicates that prudent management of the social security system requires a much larger reserve, probably as much as two year's benefits. Such a reserve is necessary to permit social security to weather a recession like that experienced in 1982 and 1983 and emerge with sufficient funds to weather another moderate recession, should one occur within the next few years. sufficient to enable continued payment of benefits during even a severe recession without the need to raise payroll taxes. A reserve of this size will not be amassed until 1997.

These facts underscore the importance of maintaining current payroll taxes and of permitting the scheduled rate increase in 1990 to take effect. Failing to do so would increase the likelihood that a spell of economic hard times would revive the aura of financial crisis that surrounded the program in the early 1980s.

But social security surpluses can serve benefits in addition to that of serving as a contingency reserve. By pursuing a fiscal policy that assures the translation of social security reserves into increased national saving, policy makers can make an important contribution to increasing the capital stock and boosting national income. Such an increase in the nation's productive capacity will enable future generations of workers to pay the increased costs of Social Security benefits

for the large future cohorts of retirees without suffering a burden from those benefits.

At the Brookings Institution, we have calculated that an increase in national saving by additions of Social Security reserves will increase national income and the consumption that it makes possible by more than the increase in Social Security costs generated by retirement of the baby-boom generation.

The key to this highly desirable result is that the surpluses accumulating in the Social Security accounts must not be used to offset deficits elsewhere in the federal budget.

To put the matter more directly, Congressional action to eliminate the deficit in the federal budget covering activities other than Social Security, while preserving social security surpluses that will arise under current procedures, is sufficient to spare future generations of workers any increased burdens for retirement pensions.

The 1988 trustees report reaffirms both that OASDI is solvent over the next seventy-five years and that HI is insolvent over the next twenty-five years. I use the term "solvent" to mean what the actuaries intend by the concept of "close actuarial balance," that outlays measured over the relevant period exceed projected revenues by no more than 5 percent. The small deficit of 0.58 percent of payroll in OASDI falls within these limits. The HI deficit of 2.37 percent of payroll--nearly half of projected costs of 5.25 percent of payroll--does not.

Through strenuous efforts Congress has shaved about 0.4 percent of payroll off both the long-term costs and deficit of part A of medicare. These steps have cut the deficit measured over the next twenty-five years by nearly one-third and significantly improved the immediate liquidity of this program. These steps have transformed the short-term financial prospects of medicare. Five years ago, the actuaries projected that the HI trust fund would be exhausted in 1991; they now project trust fund balances in excess of annual expenditures for that year.

The long-term financial problem remains qualitatively unchanged, however. Medicare costs are projected greatly to exceed currently legislated taxes. Although this deficit can be erased by enacting today increases in payroll taxes that will take effect only in the future, such a course assures that future generations of active workers will bear significantly increased costs for hospital benefits for the retired and disabled.

The justification for OASDI surpluses--that they can increase national saving and output and offset the added future costs of benefits for an increased number of beneficiaries--applies with equal force to hospital insurance and to supplemental medical insurance. The same baby-boomers who will be drawing old-age, survivors, and disability insurance will be visiting doctors and getting admitted to hospitals. Not only will an increased proportion of the population be claiming health benefits, but the cost per person of those benefits is projected to rise faster than earnings. To build up productive capacity in the

future, we should be increasing national saving now. By increasing HI taxes about 0.5 percent of payroll in 1988, to a rate sufficient to pay for benefits over the next twenty-five years, the added saving from the resulting HI surpluses will be sufficient to increase national product by more than the added cost of HI benefits.

METHODS AND ASSUMPTIONS

The 1988 actuarial projections are distinguished by a number of meritorious innovations to which I should like to draw your attention. First, the actuaries for the first time explicitly discount future revenues and outlays. In the past, the long-term actuarial balance was a simple arithmetic average over seventy-five years of outlays and revenues measured as a fraction of taxable payroll.

This year the actuaries discount future income and outgo at a rate of 2 percent. When Social Security was financed on a pay-as-you-go basis, discounting would have made no difference. Under current law, however, OASDI will run surpluses for about forty years and deficits for the next thirty-five. Discounting is necessary for reconciling flows that will occur at different times. This change improves projected long-run actuarial balance.

The second major innovation is to align the short- and long-run projections. In past years, the short-run projections were slightly more pessimistic than the long-run projections. This year the long-term projection has been brought into line with the short-term projection. This change worsens projected long-run actuarial balance.

The third set of changes involve assumptions about future economic and demographic trends. The actuaries have reduced the future assumed rates of fertility and productivity growth and increased assumed rates of immigration. The assumed fertility rates almost exactly match the actual fertility rate estimated for 1987 by Bureau of the Census. The assumed rate of immigration exceeds actual legal immigration but is less than estimated total immigration. The projected rate of productivity growth remains well above recent U. S. experience and may require further adjustment in the future. On the other hand, the 2-percent assumed discount rate is well below recent yields and may bear increasing in the future. These changes in these assumptions offset one another and have little net effect on long-run actuarial balance.

On balance, I conclude that the actuaries have prudently and responsibly adjusted their assumptions to bring them closer to recent U.S. experience. No doubt, further changes will and should be made in the future. But the actuaries have always wisely foresworn from making large abrupt adjustments in their assumptions.

Gradual adjustment of assumptions in light of actual experience is important because key variables fluctuate widely over relatively short periods of time and because large changes in assumptions have enormous effects when extrapolated seventy-five years. Because Congress customarily acts to keep Social Security within close actuarial balance,

abrupt changes in assumptions in response to events lasting only a few years may precipitate action with major long-run significance.

At present, large Social Security surpluses for the next two or three decades or even longer are highly probable regardless of assumed rates of fertility, mortality, or rates of discount. To be sure, large changes in such variables will, if they persist for decades, have a major effect on Social Security revenues or costs in, say 2060. But, in considering how quickly or strongly we should act now based on projected events seventy-two years hence, we may gain some perspective by considering how much President Woodrow Wilson and the 64th Congress would have improved decisions in 1916 based on projections made then about labor productivity, health costs, or the work week in the America of 1988.

We should continue the unique and prudent American practice of making long-term revenue and outlay projections--and we should act now to deal with the consequences of such clearly foreseeable developments as the eventual retirement of the baby-boom generation. Among other things, that means that we should act now to deal with currently projected deficits in hospital insurance. But the actuaries should be congratulated for preparing projections so that purely transitory events do not provoke capricious change in the fundamental pension program of the nation.

Chairman JACOBS. Thank you, Mr. Aaron.
Mr. Palmer.

**STATEMENT OF JOHN L. PALMER, SENIOR FELLOW, THE URBAN
INSTITUTE**

Mr. PALMER. I have a longer statement which I will submit for the record, but I will summarize it very briefly and respond a little to some of the earlier witnesses.

I won't go through the status of the trust funds. Other witnesses have done that and everybody is familiar with that. Although the projected outlays in income for Social Security are in rough actuarial balance throughout the next century under the intermediate assumptions, this does not mean we can ensure the total check resources available to support the retirement of the baby boom generation will be any larger than they would have been in the absence of this buildup.

Once the annual trust fund income is insufficient to pay annual benefits and the reserves start to be drawn down, the annual surpluses will become annual deficits which have to be financed at that point by either higher current taxes or deficits in the consolidated accounts.

Unless payroll taxes are raised or benefits cut substantially in the interim, these annual trust fund deficits cannot be avoided. They will come into being under those intermediate projections in about 30 years and grow rapidly thereafter. As earlier witnesses stressed, the simple fact is that the build up of reserves in the trust funds will be of no real benefit in easing the financial burden of the retirement of the baby boom, unless the reserve somehow increases economic growth in the interim, only then will the total economic pie available to be divided up during the retirement of the baby boom among the then aged and nonaged populations be larger than in the absence of any reserve buildup.

This will be the case only if the Social Security surpluses which are a form of public savings result in higher overall national savings and investment than would otherwise occur. They cannot have this effect if they are simply used to offset deficits and in other Federal accounts.

Unfortunately, as we know, this is exactly what is now occurring. The annual surpluses expected to total on the order of \$100 billion annually by 1993, the end of the 5-year base line projections and to continue growing thereafter are being used to avoid the need for larger and politically painful budget deficit reductions.

Were it not for these surpluses, the total base line deficit would currently be well above \$200 billion and not projected to stay at that level throughout the 1990's under current policies. If general deficit reduction doesn't continue to supply sufficient temptation, yet another threat to Social Security surpluses looms a little further down the road. Unlike the action on Social Security in the early 1980's and late 1970's, no provisions yet have been made on paper for the financing of Medicare faster than projected GNP over the next 20 years, let alone the retirement of the baby boom.

I won't go into the details on the deficits projected for Medicare in the interest of time. Clearly, there will be a temptation to use

the Social Security surpluses to finance those deficits unless measures are taken internal to the Medicare program to deal with them adequately.

Now, with this background, what I want to do to finish is just to raise what I think are three separable issues that we have all talked about and see if that can't help to clarify things a bit. And then I will give you my own response to those questions.

First is should Social Security be in the Gramm-Rudman-Hollings base for purposes of determining an appropriate target for deficit reduction? I think we have heard agreement or virtual agreement among all the prior witnesses that know it should not be. It should stand separate from the Gramm-Rudman-Hollings base.

The rest of the budget should be set on its own merits and sufficient revenue should be provided to cover whatever level of expenditures is desired in other Federal operations. Social Security surpluses should not be used to implicitly or explicitly finance other Government operations as is now the case.

A second question, though, is what should be the level of projected surpluses in Social Security, even if you did take them out of the Gramm-Rudman-Hollings base and set them aside? What is desirable in respect to this projected buildup? Do we want to continue or move back to a pay-as-you-go system or do we want to have a partially funded system, if only temporarily, through some buildup of reserves?

Clearly there are differing views among the panelists on this. I happen to believe it would be desirable to build those reserves up. I think the most important message that you are hearing is that this question and the answer to it should be viewed in what the overall context of the need for greater national savings is in the country. The Social Security surpluses are certainly not the only way and may not even be the best way to ensure that we do in fact increase our national savings rate.

But there is some political logic to using it as a vehicle for doing that. Just as an individual needs to save more to finance a longer retirement, so should society save more as relatively more of its members will also be spending more time in retirement. What more logical place to help bring about this surplus in savings than in the public programs where we have chosen to public finance a portion of retirement?

In any event, even if this argument is not compelling, I think there are merits for prudence to dictate some build up in reserves to weather future contingencies of the kind Mr. Aaron talked about. The third question, then, is if a decision is made for whatever reason to not have those projected surpluses built up as much as is now projected, then how are we to accomplish that reduction in the projected surpluses, and in particular with what interaction with the rest of the budget might this be done?

What other factors should we keep in mind? Obviously, the projected surpluses can be reduced or buildup avoided by raising benefits or cutting taxes. Either, though, would raise the current deficits in the overall consolidated Federal accounts. It is just a point in our history when we badly need to be reducing the deficits, not increasing them.

If for some reason internal to Social Security a decision might be made not to build the surpluses up, to have them reduced, through what I would think would be the most likely result, not to raise benefits but to cut taxes, I think it is critical to understand then if payroll taxes are reduced as a way of having the reserves not built up, it is important then that we exchange a tax increase over on the general revenue side to offset that reduction in payroll taxes so that at least we haven't exacerbated the overall Federal deficit problem, if we haven't in fact helped to solve it.

This might be more easily accomplished if the public understands there would be a one-for-one trade, lowering payroll taxes in exchange for possibly increasing income taxes. It would reduce the surpluses, but would also improve the balance in the Federal funds, which is where after all the huge deficits we are now facing are occurring.

Thank you.

[The statement of Mr. Palmer follows:]

John L. Palmer*

Any opinions expressed herein are solely the author's and should not be attributed to The Urban Institute or its officers or funders. For more background and elaboration on much of what is contained in this statement, see John L. Palmer, "Financing Health Care and Retirement for the Aged," in Challenge to Leadership: Economic and Social Issues for the Next Decade, edited by Isabel V. Sawhill (Washington, DC: The Urban Institute Press, 1988).

* Senior Fellow, The Urban Institute

Mr. Chairman and members of the Committee, thank you for inviting me. The subjects of today's hearings are extremely important ones about which I have given considerable thought in my work over the past several years. I am pleased to be able to discuss them with you today.

My prepared statement is divided into three sections. First, I will discuss the fiscal strain that the retirement of the baby boom will place upon public resources and the interrelationship of this with growing Social Security reserves and current federal deficit concerns. Second, I will sketch out some of the policy alternatives for dealing with the complex set of issues raised by these matters. I will then conclude with some general observations.

The Fiscal Context

The interaction of past expansions in our social insurance system, rapid population aging, the slowdown in productivity growth and escalating health care costs will place a considerable strain on public resources in the future. Just how much of a strain is difficult to quantify, because it will depend not only on future adjustments in public policies but also on the uncertain course of the economy and health care costs. One rough measure of the magnitude of the problem can be derived from projections of future expenditures for Social Security and Medicare under the policies now in effect, because these two programs currently account for more than four-fifths of all federal spending for the aged (as well as 48 percent of all domestic program spending and 29 percent of all federal outlays). Some current-policy fiscal projections (and historical data) are displayed in Table 1, using both the "intermediate" and "pessimistic" assumptions usually employed for the two programs. Obviously, they are not hard forecasts, because the assumptions on which they are based will undoubtedly change; but they at least provide some basis for thinking about the future.

Under the intermediate assumptions, the combined outlays for Social Security and Medicare creep up only marginally as a percentage of GNP over the next twenty years but then rise substantially (by about four percentage points from 7 to 11 percent of GNP) as the baby boom generation retires, before becoming relatively stable once again. But, although Social Security outlays fluctuate—going down and then rising—over the next forty years, Medicare outlays climb steadily throughout the period, greatly increasing their relative importance.¹ (The initial decline in Social Security is attributable to the 1983 amendments to the Social Security legislation, which provided for, among other things, a significant reduction in benefits relative to retiree's prior earnings, which is scheduled to phase in gradually early next century for workers who retire before age sixty-seven. Eventually though, the dampening influence of these amendments is far overshadowed by the retirement of the baby boom generation.) The continuously faster-than-GNP growth of Medicare outlays is attributable to two factors. The first is demography, including not only the general increase in the share of the aged population but also the increase within that population of the very old, who have relatively higher medical expenses. The second is increases in general health care costs per capita, which for years have greatly exceeded the rate of general inflation and are assumed to continue to do so, but by a much narrower margin.

1. The data in Table 1 (and the later Figure 1) are based on the 1987 Social Security Trustees' Report and, therefore, do not reflect some additional recent cutbacks made in Medicare hospital reimbursement. These will result in a marginal reduction in long-term Medicare outlays.

Although the intermediate assumptions supposedly reflect the current "best guess," they are more likely than not to prove optimistic, particularly with regard to real rates of growth in the economy and of health care costs.² Different assumptions about these two and other relevant variables can dramatically alter the outlay projections. As shown in Table 1 the pessimistic assumptions yield a far different fiscal outlook: combined Social Security and Medicare outlays climb rapidly over the entire projection period, increasing by ten percentage points of GNP by the end of the retirement of the baby boom generation. This pessimistic projection series merits attention not because it portrays a likely outcome, but because it illustrates the sensitivity of estimates of the future fiscal burden to variations in the assumed trajectories of key variables. However, given the rosiness of the intermediate assumptions, the outlay trends they yield under current policies may well be on the optimistic side.³

Although rapid growth in the elderly population is a major contributor to the rising costs of current policies as projected in Table 1, there is another dimension of the changing composition of the population that should serve to moderate the fiscal severity of the picture portrayed there. Because of general population aging, youth's share of the total population is expected to fall by an amount equal to about half of the increase in the aged's share by the end of the retirement of the baby boom generation. However, per capita public expenditures for the pre-working-age population are only one-fourth to one-third those for the aged; and because these expenditures are much more a state and local responsibility, this relative shrinkage in the youth population will have only a minor effect on projected federal spending under current policies. Nevertheless, the total tax burden on the working-age population (and the strain on their private resources) should be relieved somewhat by this development.

Even granting this mitigating development, if the current public commitment to financial support for the aged is not scaled back, the working population appears to be facing major tax increases to pay for this support in the long run. In a display of unusual foresight, Congress attempted to provide at least partially for this contingency in the 1983 amendments to the Social Security Act. In addition to measures designed to avert the pending bankruptcy of the program's trust funds and to reduce long-term benefit commitments, the

2. Even the pessimistic projections assume that the performance of both variables over the long run will be considerably better than it has been during the past fifteen years. For example, labor productivity increased at an average annual rate of about 1 percent since 1973, but the assumed long-run increase in the pessimistic projection series is 1.5 percent and in the intermediate series 1.7 percent. (These rates bracket the average for the past three decades.) And both sets of projections assume that inflation in health care costs, which has been running well in excess of the general rate of inflation, gradually converges to the general rate of inflation. The key demographic differences underlying the two projection series are with respect to fertility and death rates. The intermediate series assumes a modest rise in fertility rates and a slowdown in the rate of decline of mortality rates relative to the recent past. The pessimistic series assumes a somewhat faster rate of population aging resulting from both a continuing rapid decline in mortality rates and a modest decline in fertility rates.
3. The Social Security Administration actuaries also publish projections for an "optimistic" set of economic and demographic assumptions (not shown in table 8.1), which show a modest decline in combined Social Security-Medicare outlays as a percentage of GNP over the next twenty years, followed by an increase to a peak after the retirement of the baby boom that is about two percentage points higher than today's level.

amendments included provisions for increasing Social Security's future revenues sufficiently to put the program on a sound financial basis well into the next century. Most important, the earmarked payroll tax paid equally by employers and employees on Social Security-covered earnings was scheduled to increase by one percentage point between 1988 and 1990 (from a combined level of 11.4 to 12.4). And, in a significant departure from past practice, half of Social Security benefits for persons with adjusted gross incomes in excess of \$25,000 (\$32,000 for couples) were subjected to income taxation, with the proceeds also destined for the Social Security trust fund. These steps were designed to produce large annual surpluses which would accumulate as sizable reserves in the Social Security trust fund over the next two to three decades (possibly exceeding \$2 trillion) and could then be drawn down to pay for the retirement of the baby boom (see Figure 1).

However, although projected outlays and income for Social Security are in rough actuarial balance over the next fifty or so years under the intermediate assumptions, this does not necessarily mean that the total economic resources available to the population during the retirement of the baby boom generation will be any larger than they would have been in the absence of this build-up of reserves. Once the crossover point is reached (about 2019 in Figure 1) and the reserves start to be drawn down, the annual surpluses will become annual deficits, which will then have to be financed by either higher current taxes or growing deficits in the consolidated account. If the reserves in the Social Security trust funds are to be of any real benefit in easing the financial burden of the retirement of the baby boom, they must be used to enhance economic growth in the interim, so that the total economic pie that is available to be divided up among the aged and nonaged population is larger than it otherwise would have been. This will be the case only if the Social Security surpluses, which are a form of public savings, result in higher overall national savings and investment than would otherwise occur. But they cannot have this effect if they are used simply to offset deficits in other federal accounts.

Unfortunately, this is what is already occurring. As you well know, the annual Social Security surpluses—which are expected to total \$97 billion (nearly 1 1/2 percent of GNP) by 1993 and to continue growing—are being used to avoid the need for even larger politically painful on-budget deficit reductions. Were it not for these surpluses, the total federal baseline deficit would be well above \$200 billion and not projected to decline in the 1990s under current policies (see Table 2).

If general deficit reduction does not continue to supply sufficient temptation, yet another threat to the Social Security surpluses is looming a little further down the road. Unlike the action on Social Security, no provision has yet been made even on paper for the financing of Medicare's projected faster-than-GNP growth over the next twenty years, let alone the retirement of the baby boom. Medicare has two components. The larger one, Hospital Insurance (HI), accounts for about 60 percent of total program outlays and is financed by a 2.9 percent (combined employer-employee) payroll tax on Social Security-covered earnings. In the mid 1990s HI will begin to run annual deficits that, even under the intermediate assumptions, will deplete its trust fund soon after the turn of the century and will exceed 1.6 percent of GNP (3 percent of payroll) once the baby boom generation is retired (see Figure 1). Medicare's other component, Supplemental Medical Insurance (SMI), which covers physician and outpatient services, is financed one-quarter from enrollee premiums and three-quarters from general revenues. Consequently, under this arrangement, as SMI outlays continue to rise relative to GNP, so, too, will the tap on general revenues required to finance the program. Under these conditions, it will be politically tempting to reallocate the Social Security surpluses in order to postpone Medicare's day of reckoning or to finance new health care benefits for the aged.

In sum, the interaction of population aging population, public policies, and rising health care costs has resulted in a substantial increase in the share of total economic resources being devoted to the support of the aged population over the past several decades, and this share undoubtedly will continue to increase over the foreseeable future. By how much is difficult to predict, because the amount will depend on the uncertain course of the economy and health care costs, among other things, as well as on future adjustments in public policies in support of the aged. However, it appears likely that the revenues necessary to finance projected expenditures under current policies would have to increase modestly over the next two decades and by at least 4 percent of GNP by the end of the retirement of the baby boom—with the bulk of the increase earmarked for health care. And this, of course, does not take into account any possible increase in federal expenditures to finance either catastrophic acute health care for the aged or their rapidly growing long term health care needs. In the meanwhile, surpluses in the Social Security trust funds, which could be used to augment national savings and investment and ease the eventual fiscal burden of the retirement of the baby boom, are not doing so. Instead they are essentially being used to finance other current federal expenditures, their off-budget status notwithstanding.

Policy Options

The policy options that might be considered to deal with the complex set of issues raised by this fiscal picture are obviously too numerous and varied for me to deal with in any comprehensive fashion here. All of them are politically unattractive, since they involve the need to worry about ways of dealing with the long-term fiscal gap that the aging of the baby boom will impose on top of the existing problem of the federal deficit. However, both problems must be faced up to, and the sooner the better. Here, I will attempt to sketch out a few of the major alternatives that I believe to be the most fruitful as a basis for further discussion after the formal presentations by panel members this morning.

The most immediate implication of the fiscal picture I have just outlined is that the projected Social Security surpluses should not be used to finance, either implicitly or explicitly, other federal expenditures including Medicare.⁴ That is, the goal for general deficit reduction over the 1990s should be to more or less balance the books exclusive of the currently projected annual Social Security surpluses. This, of course, will be no mean feat, since achieving a balanced budget even inclusive of Social Security is proving to be so politically difficult. Nevertheless, this is the objective for which we should strive in the design of our overall fiscal policies.

Even if this objective is met we will still have a longer run problem to deal with, which will eventually require some combination of an increase in taxes on the working age population and reduction in the current commitment for public financing of health care and retirement benefits for the baby boom in their aged years. I will return to the former issue later, but first let me indicate that I believe the greatly improved current and prospective economic status of the aged provides scope for some of them to shoulder more of the burden for financing their retirement and health care without undermining the improvements in economic security already achieved for them (i.e., while still preserving the essential functions of the current social insurance system for them). It is important to note at the outset, however, that the desirability of preserving that system has been increasingly called into question in recent years. Numerous proposals (politically unthinkable a decade ago) have cropped up for replacing the current system with private provision ("privatization")

4. Indeed, an argument could be made that surpluses should be accumulated in the Medicare trust funds, just as in Social Security, in anticipation of the retirement of the baby boom.

for retirement and health care for the vast majority of the aged, accompanied by expanded provision of means-tested benefits (as in Medicaid and SSI) to cushion the consequences for the less fortunate. At the very least, proponents of privatization argue, the current working generation ought to be given the choice of opting out of the social insurance system. Such partial or total privatization, it is alleged, not only is more in keeping with the American ideology of individualism and free markets, but also would reduce taxes on the working population and solve the fiscal problem posed by rapid aging of the population.

The issues raised by various proposals for privatization and means testing are too complex to discuss fully here. But it is worth noting the major opposing arguments, because they are sufficiently compelling to justify the focus here on less extreme adjustments to current policies. Briefly, these arguments are as follows.

First, it is true that switching from our present social insurance system for the aged to a system much more oriented to the private sector could eventually permit a sizable reduction or elimination of the current sources of taxation supporting Medicare and Society Security. But because of the present reliance on pay-as-you-go financing, unless social insurance benefits were abruptly terminated (which would be neither politically feasible nor socially fair), the current and near-future generations of working taxpayers would have to finance two systems: the current public one for the aged and near-aged populations and another one financed through added private savings for themselves. This would approximately double the expenditures for these purposes for these households.

A second argument against privatization is that private insurance markets are generally unable to provide actuarially fair policies. The primary reason for this is that the risk of adverse selection—the ability of low-risk persons to opt out of insurance—means that actuarially fair insurance markets simply do not exist, except where participation is compulsory (as for Social Security and Medicare). Furthermore, the private market—unlike the public one—cannot guarantee a steady flow of real income during retirement (for any given amount of savings over the working years) because of the uncertainties posed by fluctuations in inflation and interest rates.

Beyond these two arguments is the overriding fact that, in contrast to many public programs, Social Security and Medicare have been extremely successful in accomplishing their objectives and have earned unusually strong and widespread support among Americans of all ages. They were created and have thrived because the alternatives were unacceptable to the overwhelming majority of the public. These programs are particularly popular among the broad middle class, many of whom would otherwise experience substantial hardship in their middle years from supporting their parents and to whom the prospect of having to rely on their own children or "demeaning" means-tested public programs in their own old age is fearsome indeed. Surveys as recent as the mid-1980s have shown that, despite some lack of confidence in the future ability of the system to provide for their retirement, even two-thirds of young adults thought that Social Security taxes were fair and that their level was about right or too low.⁵

In short, some modifications in our social insurance system for the aged appear to be needed to respond to changing circumstances, but privatization as a solution looks like another case of the proverbial baby and bath water.

5. Hugh Heclo, "Generational Politics," in *The Changing Well-Being of Children and the Aged* edited by John L. Palmer, Timothy Smeeding, and Barbara B. Torrey (Washington, D.C.: The Urban Institute Press, forthcoming).

What, then, are the most promising ways to alter social insurance programs to increase the burden on the aged for the financing of their retirement and health care while still preserving the essential functioning of the current social insurance system? Several are possible, but they all share certain general characteristics. The wide array of options boils down to two fundamental approaches: the burden can be increased in a way that either is or is not related to income. Refinements come into play over the implementation of these approaches. The increased burden can be achieved directly, through explicit reductions in benefits, or indirectly, through measures such as taxation of benefits or increased premiums in the case of Medicare. Also, timing is important: changes could affect the aged of today or only those after some future date.

The advantages of income-related approaches are obvious in light of the considerable heterogeneity in the economic status of the elderly population. In particular, income-related approaches can minimize the adverse consequences for the lower- to middle-income aged, who currently are highly dependent on Social Security and Medicare to maintain their prior standards of living and avoid poverty. But income-related approaches are not without their disadvantages. One problem is the potential for administrative complexity. The implementation of non-income-related approaches requires no new information about recipients, whereas income-related approaches require information about the income not only of recipients, but also of their households. Neither type of income information is currently collected by Medicare or Social Security, and instituting any mechanism to do so would be a complex and costly undertaking for the government and an undesirable imposition on recipients and their families. For these reasons, use of the tax system to accomplish the income-relating process is vastly preferable, even though some precision in targeting might be lost by less-than-ideal definitions of income or family unit.

A second disadvantage of income-related approaches is their potential for undermining political support for the programs. This erosion of support could be widespread—because of a generally perceived violation of the "earned right" concept underpinning social insurance—or it could be concentrated among higher-income recipients, who might increasingly perceive social insurance as a bad deal for them, because their added burden would be much larger. (Non-income-related approaches obviously also have this potential, but to a lesser degree.) Although this concern is legitimate, there are several mitigating factors. The first is that the sine qua non of our social insurance system—universal eligibility for all workers (and their dependents, where relevant) with covered earnings—would be retained. The "earned right" would still be there; only the net benefit ultimately derived would be affected. Second, to the extent that taxation of benefits is the chosen instrument, benefits would simply be treated on a comparable basis with other sources of income, such as private pensions, that are currently included in the tax base, in accordance with our collective notion of what constitutes ability to pay. Finally, when all is said and done, our current system of social insurance constitutes a "good deal" even for prospective higher-income recipients. By virtue of being in on the early stages of a pay-as-you-go system, retirees at all income levels are currently receiving benefits of value far beyond what they contributed. And although the "windfall" component of benefits for new retirees is now declining rapidly with the maturation of the system and changing demography, it has a long way to go before calculations of self-interest should become problematic.⁶

-
6. Assessing just how good a deal Social Security is for current and prospective elderly persons is an extremely complex matter. The assessment is highly dependent on the specific circumstances of individuals (for example, their age at retirement, their position in the income distribution, their life expectancy, whether or not they receive

While I stated at the outset of this discussion of policy options that removing the Social Security surpluses from consideration in current federal deficit concerns would be ideal, I also recognize that this may not be politically feasible. The temptation to use these projected surpluses to continue to finance other federal expenditures, or new ones for the aged, or simply to grant payroll tax relief, may prove to be too politically tempting. Furthermore, this temptation could be further exacerbated if some of the measures I just suggested to deal with the long run problem were adopted in the near term, this leading to an increase in revenues earmarked for the trust funds, and therefore, the size of the surpluses.

In light of this temptation, an alternative approach would be to consciously take steps to reduce these projected annual surpluses by reducing earmarked Social Security taxes. However, if this is done, care must be taken to ensure that there is a (1) commensurate short-term increase in general revenues that is applied to general deficit reduction and (2) a commensurate decrease in long-term Social Security benefit commitments beyond that which would be planned in any event to close the fiscal gap which will arise during the retirement of the baby boom. Perhaps the simplest way to accomplish the former would be to "unearmark" the proceeds from income taxation of Social Security benefits so that they would become general revenues rather than flowing into the trust fund reserves. This taxation is currently projected to yield nearly \$6 billion by 1992 and, if expanded by reducing the AGI thresholds above which it applies and/or subjecting to taxation a greater proportion than the current 50 percent of benefits, could yield an additional \$10-\$20 billion. (It is important to note, however, in line with point (2) just above, that unless steps are also taken to reduce future benefit commitments by an amount that would roughly offset the future loss of revenues attributable to the currently scheduled degree of income taxation of benefits, unearmarking these proceeds will add to the annual Social Security deficits that will begin soon after the retirement of the baby boom.) A more complex approach would be to reduce scheduled payroll tax rates in return for an explicit increase in income or other general revenue taxes (again with a commensurate decrease in Social Security benefit commitments in the long term).

Conclusion

There is a growing gap between projected public expenditures for the aged and the share of GNP currently devoted to supporting such expenditures. Substantial adjustments in current policies are both desirable and inevitable, although just how substantial is impossible to specify with any precision, because the answer depends in part on the uncertain size of the fiscal gap and future economic gains of the aged.

Footnote continued from previous page

dependents' benefits), the assumptions made about the future course of the economy (especially real interest rates), whether only payroll taxes paid by workers or those paid by both workers and their employers are considered, and the value placed on such things as Social Security's ability to guarantee a steady flow of real income during retirement (which, as noted earlier in the text, cannot be done by private annuities). The numerous studies that have been done vary considerably in the way they deal with these matters and, therefore, in the conclusion they reach. They all agree (1) that all current retirees, especially those with high earnings histories, receive benefits from Social Security far in excess of any contributions made over their working lifetime and (2) that this excess value will be declining over time for successive future groups of retirees, with the net redistributive effects of Social Security among these groups becoming more progressive. However, it is impossible to arrive at any definitive answer to the question of just how good (or bad) a deal Social Security will prove to be for today's youth or young workers, based on these analyses.

One clear lesson to be drawn is that population aging should further compel us to deal with two issues that presumably would be high on the public agenda in any event--the promotion of long-term economic growth and the control of cost inflation in health care. Here it is worth underscoring two points:

(1) If the Social Security surpluses are to make a meaningful contribution easing the fiscal burden attendant to population aging, they must not be used for other purposes, including general deficit reduction. (2) Because escalating real health care costs are not limited to Medicare or the aged, any approach to restraining those costs that will be both effective and capable of sustaining public support in the long run will have to go far beyond changes in Medicare reimbursement to more fundamental changes in the way the nation organizes and finances the provision of health care in general.

I have also alluded to various approaches to modifying Medicare and Social Security in line with the growing capability among some of the aged to shoulder more of the burden for the financing of their retirement and health care. In the immediate future these measures could be used to finance any expansion in assistance to the aged or to contribute to general deficit reduction. Eventually they could at least partially alleviate the increased pressures on the public purse that will attend the retirement of the baby boom.

Here it is important to establish priorities among the measures discussed. Income-related approaches that operate through the tax system are strongly preferable. They would concentrate the added burden on those among the aged who are in the best position to bear it. Of course, as noted earlier, there are limits to how far income-related approaches can be pushed before they become widely viewed as inequitable to higher-income aged people. Thus, depending on how much of the growing fiscal burden is ultimately borne by the aged rather than by the working population (through higher taxes), some across-the-board measures might eventually be considered desirable. However, across-the-board measures will be less problematic if they apply only to future groups of the aged, because even the lower-income members of these groups would have the advantage of greater overall financial resources and a longer lead time with which to adjust.

The desirability of such a lead time for adjustment is only one of several reasons why the nation needs to focus now on the kind of policy adjustments discussed in this chapter. Pressures for general deficit reduction and selective expansion of benefits will continue to motivate more immediate changes in social insurance and other programs serving the aged, and actions to greatly improve Medicare's fiscal outlook will be required in the next decade. Furthermore, whereas Social Security, per se, may be on sound financial footing for the next few decades, its rapidly accumulating reserves are already generating strongly conflicting views on their desirable disposition. A coherent longer-range vision of how our society wants to finance retirement and health care for the aged is needed, so that any potential changes in public policies can be assessed on the basis of their consistency with such a vision and appropriate adjustments in the behavior of individuals and private institutions can be fostered. Otherwise the country may have to make more wrenching and less palatable changes in public policies and private circumstances in the future.

Many people tend to pose the issue as one of inevitable conflict between the aged and nonaged populations. Changes in taxes on the working-age population clearly will have to be part of the equation. But it is important to keep two points in mind concerning the trade-off between relatively lower benefits for the aged and higher tax burdens on the nonaged.

First, today's working-age population will be tomorrow's aged population. Thus, in the longer run, the issue is not "us" versus "them" but the role all Americans would like to see public policies play in promoting economic security over their lifetimes. Less consumption when people are working will increase

the economic resources available later and vice versa. The overall structure of taxes and public benefits will be an important determinant of the prevailing lifetime pattern of resource usage.

Second, Americans of tomorrow in all age groups will almost certainly have a much higher level of material well-being than American in similar age groups have today. In the four decades following World War II, per capita real GNP increased at an average annual rate of nearly 2 percent, leading to more than a doubling of the overall standard of living. Even if this rate of growth were to slow to, say, 1.5 percent annually (about that assumed in the intermediate projections in Table 1), per capita real GNP would double once again by the time the baby boom generation is fully retired. Under these circumstances, closing a fiscal gap of 4 or even more percent of GNP certainly need not entail an onerous burden from today's perspective--so long as this burden is distributed reasonably equitably both between and within the aged and nonaged populations. Developing consensus on just what constitutes equitable distribution will be an arduous task for political leadership. But if the task is pursued in the context of policies to enhance long-term economic growth and constrain cost inflation in health care, it need not prove herculean.

TABLE 1

Current Policy Projections of Social Security and Medicare
Expenditures as a Percentage of GNP, 1990-2050

	Social Security	Medicare ^a	Total
Historical data			
1965	2.4	(b)	2.4
1970	2.9	0.7	3.6
1975	4.0	0.9	4.9
1980	4.3	1.2	5.5
1985	4.7	1.7	6.4
Projections			
Intermediate assumptions			
1990	4.7	2.1	6.8
1995	4.7	2.3	7.0
2000	4.4	2.5	6.9
2005	4.2	2.8	7.0
2010	4.4	3.0	7.4
2015	4.9	3.2	8.1
2020	5.6	3.7	9.3
2025	6.2	4.2	10.4
2030	6.5	4.5	11.0
2035	6.5	4.8	11.3
2040	6.4	4.8	11.2
2045	6.3	4.8	11.1
2050	6.2	4.8	11.0
Pessimistic assumptions			
1990	5.2	2.3	7.5
1995	5.2	2.8	8.0
2000	4.9	3.3	8.2
2005	4.8	3.8	8.6
2010	5.0	4.5	9.5
2015	5.6	5.3	10.9
2020	6.5	6.3	12.8
2025	7.3	7.6	14.9
2030	8.0	8.5	16.5
2035	8.3	9.0	17.3
2040	8.5	9.1	17.6
2045	8.7	9.1	17.8
2050	9.0	9.0	18.0

SOURCES: For 1965-1985, Historical Tables of the Federal Budget; for 1990-2050, 1987 Annual Report of the Social Security Board of Trustees of the Federal Old Age, Survivors Insurance, and Disability Trust Funds.

a. This includes both the Hospital Insurance (HI) and Supplemental Medical Insurance (SMI) components of Medicare. Long-term projections are provided by the Medicare actuaries only for HI. SMI outlays are assumed to rise from 63 percent of HI outlays in 1990 to 66 percent in 1992 (as in the Congressional Budget Office's five-year projections) and then to remain a constant 66 percent of the HI outlays.

b. Medicare was not implemented until the late 1960s.

TABLE 2

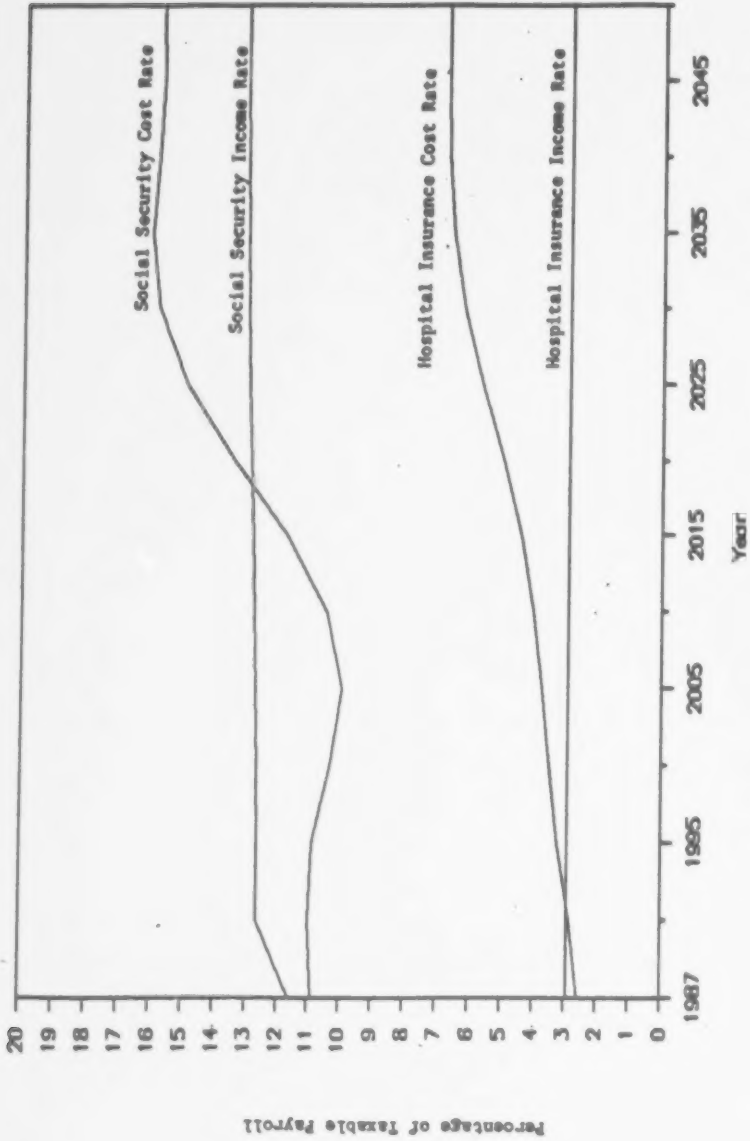
CBO Baseline Deficit Projections Excluding and Including Social Security
(by fiscal year, in billions of dollars)

	1988 Base	Projections				
		1989	1990	1991	1992	1993
Deficit excluding Social Security	195	222	225	229	232	231
Social Security surplus	37	46	58	71	81	97
Deficit including Social Security	157	176	167	158	151	134

SOURCE: CBO, The Economic and Budget Outlook: Fiscal Years 1989-1993, Table II-3.

FIGURE 1

Annual Cost and Income Rates for Social Security and Medicare Hospital Insurance
Under Current Policies and the Intermediate Assumptions 1987-2050



SOURCE: 1987 Annual Report of the Board of Trustees of the Federal Old Age, Survivors Insurance, and Disability Insurance Trust Fund.

Chairman JACOBS. The comment that Mr. Palmer just made was running through my mind already. That is, if you did cut the Social Security tax, would you anticipate the Federal funds budget picking up the reduction in terms of general revenue increases.

Mr. MYERS. I think that what I call the general budget deficits that we have, which are of horrendous size, ought to be solved one way or the other, either more taxes or reductions in expenditures. Although these are related, they don't have to happen simultaneously. If you look at the general budget, something ought to be done about it.

If Social Security doesn't appear to be helping these budget deficits, maybe something else should.

Chairman JACOBS. I get this strange notion, if you cut Social Security taxes and simultaneously increase Federal income taxes, you have done indirectly what it takes by direction. Haven't you in a sense taken Social Security assets and applied them to the Federal funds budget?

Mr. MYERS. I would put it a different way. I would say that you realistically recognized that the general budget was way out of balance and you were doing something about it directly, and not doing it under the guise of having Social Security payroll taxes do so.

Chairman JACOBS. Mr. Palmer said that either implicitly or explicitly the funds were being used now. That is a disjunctive. I assume you meant implicitly it is being used now. I guess you would agree, Bob, if you relieve the pocketbook on the OASDI side, that you did create some capacity for new revenues to the Federal funds budget. Is it illogical to say in a sense there is a fault—you have taken assets or Social Security assets to apply to B-1 bombers, or whatever they are.

Mr. MYERS. I suppose that it could be viewed that way. I am afraid that, with the huge Social Security fund of trillions of dollars, you are going to have great and irresistible pressures to liberalize benefits. Then, you are going to be worse off than when you started.

Chairman JACOBS. There is the next one. Against that is the question about whether you do, if you are a baby boomer, whether you pay as you go or whether you receive as you go, when you get to retirement age. That strikes me as something of a dilemma as well. I can't reconcile your proposal with the advice of Joseph in the Bible, somehow or another.

Is that classic learning in economics? I don't know. Seven lean years and so on and so forth, it seems as though life is a lot more fun when you put something aside in the good years for the bad years, rather than the way I think the Federal Government has more or less tended to operate, which is commonly known as human nature.

Why does the Government borrow money? Because it can. If it couldn't, it wouldn't and therefore it would not have the capacity to do some of the spending that some people criticize, I suppose.

Does any member of the panel have a comment on the suggestions I earlier made to Mr. Hartman concerning the repeal of 30 percent withholding?

In other words, the repeal of taxation on income to foreign nationals from investment in the United States or is that a trick

which is subject to the great conspiracy of silence reducing the pressure on money markets of the United States. It would be like saying that Red China exists in the 1950's. What is the big secret.

Mr. AARON. There are a lot of meritorious ideas that I think should be considered along with those. The effect on revenues from abroad would be, I think, relatively marginal, because although, as you stressed, we know the sign, we just don't know the size. The fact is that most acquisitions of the U.S. dollars in the past years have been in official holdings of governments, in Asia, Europe, throughout the world.

We don't tax foreign governments, so that at least as far as the bulk of the increase in dollar holdings abroad, the tax wouldn't apply. As far as financial markets are concerned, that is a different matter, and I suppose perhaps a bit facetiously I would suggest if we are going to withhold interest, we might start at home.

Mr. MYERS. Mr. Chairman, I think that it might be noted that the 30-percent withholding still does apply to income tax on Social Security benefits of people living abroad.

Chairman JACOBS. Yes.

Mr. Aaron, you really don't agree with Chairman Gibbons that we dare not reinstate the tax on the foreign nations, or the U.S. Government would have insufficient sources for further borrowing?

Mr. AARON. I am for withholding taxes generally across the board.

Chairman JACOBS. Can we agree the repeal of the 30 percent withholding had the effect of repealing the tax?

Mr. AARON. Yes.

Chairman JACOBS. Have you any comment?

Ms. MUNNELL. No.

Chairman JACOBS. We thank you for your contributions to the record. You were most generous.

[Whereupon, at 2:25 p.m., the hearing was adjourned.]

APPENDIX

SUMMARY OF 1988 TRUSTEES' REPORT

I Old Age, Survivors and Disability Insurance Trust Funds

A. Overview

1. Under alternative II-B intermediate assumptions, the OASDI trust funds are in close actuarial balance over the next 75 years.¹ For the next three decades, the trust funds will run a positive annual balance. During this period, reserves will accumulate, reaching a peak in 2015. As the baby boom generation begins to retire, the annual trust fund balances turn negative. The accumulated reserves are then sufficient to pay benefits until 2048 when the funds are depleted.

2. The DI trust fund is not in close actuarial balance in the long-run under the II-B assumption. In the short-run, adverse economic conditions could result in depletion of the DI trust fund in the next 10 years. The Trustees suggest that the DI fund could be brought into balance by a slight reallocation of the contribution rate between the OASI and DI funds.

3. In the near-term (1988-1992), the combined OASDI trust funds are projected to be healthy under all sets of assumptions. This assumes no major changes in legislation or regulations.

4. In the first 25-year period (1988-2012), there is a positive balance of 2.24 percent of taxable payroll under II-B assumptions. The income rate is 12.78 percent and the cost rate is 10.54 percent.

5. Over 50 years (1988-2037), a positive balance of 0.53 percent of payroll is projected. The income rate over the period is estimated to be 12.87 percent and the cost rate to be 12.34 percent. The contingency fund ratio will reach a maximum of 531 percent in 2015.

6. Over the 75-year period (1988-2062), the reserves will continue to decline. The income rate is projected to be 12.94 percent and the cost rate 13.52 percent for a balance of -0.58 percent of payroll.

¹The report uses a new method of calculating "close actuarial balance" (known as "level financing"). It discounts future surpluses and deficits using the real rate of interest. A method similar to the level financing method was used prior to 1973. The report presents projections under both the new method and the old "average cost" method which did not fully recognize the interest earnings on trust fund assets. Under the old method, the trust funds are not in close actuarial balance.

B. Key Demographic and Economic Assumptions

1. The II-B estimates assume an ultimate fertility rate of 1.9 children per woman. This is a reduction from the long-range projection of 2.0 used in the last several trustees' reports. Historically, fertility rates rose during the 50's to a high of 3.6 in 1960. They began to decline in the 70's and have leveled off at about 1.8 in the 80's.

2. This year's report increases the assumption for net annual immigration. In addition to 400,000 net legal immigrants, the trustees assume 200,000 net "other-than-legal" immigrants per year.

3. This year's report reduces the long-term real wage differential under II-B from 1.5 percent to 1.4 percent.

4. Under II-B, real GNP growth is projected to be between 2 percent and 3 percent until the year 2010 and to be 1.9 percent thereafter; the long-term increase in the CPI is assumed to be 4.0 percent; and the average interest rate is projected to be 6.0 percent beginning in 2000.

5. In addition to the changes in assumptions with respect to fertility, immigration and real wage growth, there were a number of minor changes in assumptions. The net effect of all changes on the long-range actuarial balance was small.

C. Cost of Social Security as A Fraction of GNP

In 1988, the cost of the OASDI program as a proportion of GNP equals 4.70 percent. Under II-B assumptions, social security as a share of GNP will decline in the next two decades to a low of 4.39 in 2005 and will then increase to 6.19 percent by 2025 and then rise to a peak of 6.61 percent by 2035. After 2035, it will level off at about 6.5 percent.

D. Social Security Tax Rates Under Current Law

Year	OASI	Employer and Employee Rate			
		DI	OASDI	HI	OASDHI
Public Law 98-21					
1985-87	5.20	.50	5.70	1.45	7.15
1988-89	5.53	.53	6.06	1.45	7.51
1990-99	5.60	.60	6.20	1.45	7.65
2000-later	5.49	.71	6.20	1.45	7.65

ANDY JACOBS, JR., INDIANA, CHAIRMAN
SUBCOMMITTEE ON SOCIAL SECURITY

RICHARD A. GEMMART, MISSOURI
SALU H. GIBSON, FLORIDA
SANDER H. LEVAL, MICHIGAN
ONE MOORE, KENTUCKY

BILL ARCHER, TEXAS
PHILIP M. CRANE, ALABAMA
RAL SAUS, NEBRASKA

By Office:
DAN ROSTENKOWSKI, ILLINOIS
JOHN J. DUNCAN, TENNESSEE

DAN ROSTENKOWSKI, ILLINOIS, CHAIRMAN
COMMITTEE ON WAYS AND MEANS

ROBERT J. LEONARD, CHIEF CLERK
MR. EDWORTH BOWLER, STAFF DIRECTOR
SANDRA CAMBER WARE, SUBCOMMITTEE STAFF DIRECTOR

A.L. BRIDGEMAN, MINORITY CHIEF OF STAFF
EAREN S. WORTH, SUBCOMMITTEE MINORITY

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, DC 20515

SUBCOMMITTEE ON SOCIAL SECURITY

May 18, 1988

Mr. Robert Myers
9610 Wire Avenue
Silver Spring, Maryland 20901

Dear Mr. Myers:

I very much appreciate your contribution to our hearing on May 10th regarding the social security trust fund reserves.

Attached are several questions from Members of the Subcommittee who were unable to attend the full hearing. They would appreciate your expert opinion on these questions for inclusion in the official hearing record.

I would appreciate it if you could provide the Subcommittee with a response by May 27, 1988.

Sincerely,

Andy Jacobs, Jr.
Chairman

AJ/wd

Enclosures

Questions for Robert Myers from Rep. Archer**QUESTION NO. 1 FROM MR. ARCHER:**

How do you think today's workers, many of whom are in the baby boom generation, would perceive a return to pay-as-you-go financing as you propose? Would they appreciate the tax cut, or worry more that Congress is again tampering with the system?

Answer:

I believe that, if proper educational efforts and explanations are made, they will approve of the tax reduction for the next few decades resulting from a return to pay-as-you-go financing. They will not consider this as tampering with the system, but rather as a necessary adjustment to maintain the pay-as-you-go financing basis that both the Congress and the Board of Trustees had explained, for many years, as being the proper method.

QUESTION NO. 2 FROM MR. ARCHER:

If we were to return to pay-as-you-go financing, how would we respond to the issue of generational equity? As the program has almost matured--that is today's workers have contributed close to 40 years--isn't it appropriate to consider a more uniform return on the taxes contributed?

Answer:

It is true that a return to pay-as-you-go financing is not in the direction of intergenerational equity. However, this disadvantage is far more than offset by the advantages involved -- the elimination of the budget deception (including the gigantic problems when the fund's investments would be liquidated some four decades hence) and the perhaps irresistible temptations and pressures to liberalize benefits because "the fund has so much money".

QUESTION NO. 3 FROM MR. ARCHER:

Some 60 years down the road the system will be exhausted. There are alternatives to increasing payroll taxes--for example increasing the reduction or phasing up the age for early retirement, or placing greater reliance on IRA's. Do you think we should enact any such measures and encourage tomorrow's workers to rely a little less on social security in their retirement planning? If you concur, what alternatives would you advocate and why?

Answer: It would be desirable now to incorporate a tax schedule in the law that would, according to the intermediate estimate, finance the program in and beyond the 75-year valuation period. Of course, because of the variability of actuarial estimates as against actual developing experience, changes of some sort would be necessary over the future. Part of the change might well be a further increase in the Normal Retirement Age, letting it rise to age 68 (as the Committee on Ways and Means considered in 1981). This could be done, for example, by continuing the present increase schedule (based on year of attainment of age 62) beyond 2005 until the NRA becomes age 68 for those attaining this age in 2026. This would be instead of having it remain level for those attaining age 62 in 2006-16 and then again rising until the NRA is 67 for those attaining this age in 2027. Other slower procedures could be developed.

If the Early-Retirement Age is raised -- which is logical, but should not be used for cost-reduction purposes -- the reduction factors should be maintained as "actuarial" ones. Any attempt to reduce costs by making the reductions larger than "actuarial" will not be productive; those who are financially able to do so, even though they actually retire at an early age, will not claim "actuarially unfair" amounts -- but rather will wait until the Normal Retirement Age to do so.

QUESTION NO. 4 FROM MR. ARCHER:

I note you believe that the trustee's method of measuring "close actuarial balance" needs to be reexamined. Can you elaborate? Is it something you believe the next Advisory Council should consider?

Answer:

I believe that the revision made in the 1988 OASDI Trustees Report -- by recognizing interest over the years and the existing trust-fund balances -- was a big step in the right direction. In addition, allowance should be introduced to build and maintain a 1-year fund balance, to recognize the situation existing after the end of the 75-year valuation period, and to de-emphasize, either qualitatively or quantitatively, the cost experience of the distant portion of the 75-year period. As to the last-mentioned, the question of "close actuarial balance" should be based on several criteria (including a 50-year valuation period, as well as the 75-year one).

The next Advisory Council on Social Security should most certainly consider this matter.

Questions for Robert Myers from Rep. Crane

QUESTION NO. 1 FROM MR. CRANE:

If we were to enact legislation along the lines you are proposing, would it be prudent to cushion out or spread out the peak tax years? If so, what upper limits for FICA/SECA would you recommend?

Answer:

I strongly believe that the Social Security program and the general budget situation would be better off and more stable not only if the increase in the tax rate for 1990 were repealed, but also if the rate for 1989 and after were reduced to the lower rate applicable in 1987. In combination with this action, a pay-as-you-go tax schedule (and statement of principle) should be incorporated into the law.

QUESTION NO. 2 FROM MR. CRANE:

Would the social security program and perhaps the economy as a whole be more stable if we repealed the accelerated tax schedule for 1990, and let the payroll tax revert to a pay-as-you-go basis?

Answer:

It would readily be possible (and desirable) to develop a pay-as-you-go tax schedule for the future that would not have sharp increases at any time (and that would build up the OASDI fund balances to a more desirable level -- i.e., higher -- than now, say to a "1-year outgo" size).

It is not possible to give a precise answer as to the desirable ultimate level of FICA/SECA tax rates. If the present benefit structure were to be maintained, the ultimate employer and employee rates would have to be about 1½% higher for each party (as would also be the case under present law). Such rates could be increased less than this if benefit changes (such as increasing the Normal Retirement Age) were made.

ANDY JACOBS, JR., INDIANA, CHAIRMAN
SUBCOMMITTEE ON SOCIAL SECURITY

RICHARD A. GEPHARDT, MISSOURI
SAM M. ORBORN, FLORIDA
SAMUEL M. LEVIN, MICHIGAN
JIM WOODY, WISCONSIN

BILL ARCHER, TEXAS
PHILIP M. CRANE, ILLINOIS
PAUL DAHL, MINNESOTA

Ex Officio:
DAN ROSTENKOWSKI, ILLINOIS
JOHN J. DUNCAN, TENNESSEE

DAN ROSTENKOWSKI, ILLINOIS, CHAIRMAN
COMMITTEE ON WAYS AND MEANS

ROBERT J. LEONARD, CHIEF COUNSEL
M. EDWYTH BOWLER, STAFF DIRECTOR
BARBARA CASAR, WIFE, SUBCOMMITTEE STAFF DIRECTOR

A.L. SIMULTON, MINORITY CHIEF OF STAFF
KAREN R. WORTH, SUBCOMMITTEE MINORITY

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, DC 20515

SUBCOMMITTEE ON SOCIAL SECURITY

May 18, 1988

Ms. Alicia Munnell
Senior Vice-President and
Director of Research
Federal Reserve Bank of Boston
600 Atlantic Avenue
Boston, Massachusetts 02106

Dear Ms. Munnell:

I very much appreciate your contribution to our hearing on May 10th regarding the social security trust fund reserves.

Attached are several questions from Members of the Subcommittee who were unable to attend the full hearing. They would appreciate your expert opinion on these questions for inclusion in the official hearing record.

I would appreciate it if you could provide the Subcommittee with a response by May 27, 1988.

Sincerely,

Andy Jacobs, Jr.
Chairman

AJ/wd

Enclosures

Questions for Alicia Munnell from Rep. Archer

1. If we were to consider Mr. Myer's alternative financing, how do you think today's workers, many of whom are in the baby boom generation, would perceive a return to pay-as-you-go financing? Would they appreciate the tax cut, or worry more that Congress is again tampering with the system?
2. Some 60 years down the road the system will be exhausted. There are alternatives to increasing payroll taxes as you project--for example increasing the reduction or phasing up the age for early retirement, or placing greater reliance on IRA's. Do you think we should encourage tomorrow's workers to rely a little less on social security in their retirement planning? If you concur, what alternatives would you advocate and why?
3. Can you elaborate a bit on the investment experiences of Sweden, Japan and Canada? Where did they invest the surplus and what has been their experience?

Responses to questions from Rep. Archer

1. No change need or should be made to the Social Security system for at least five years. The singularly most important thing to do is to accumulate an adequate contingency reserve so that the system never again experiences the kind of short-term financial crises that arose in the late 1970s and early 1980s. To do this requires that reserves build to a level equal to roughly 150 percent of annual outlays and this will not occur until 1995 according to the Social Security actuaries' intermediate assumptions. After that time decisions can be made about whether to return to pay-as-you-go or to continue accumulating substantial trust fund reserves. My suspicion, however, is that by the late 1990s it will become clear that the Medicare trust fund needs a serious infusion of revenue and that the problem can be solved by reallocating part of the excess OASDI payroll tax to HI. Hence, I do not see a payroll tax cut in the offing regardless of which path we chose to follow.

2. In my view, the current level of Social Security benefits, as a percent of preretirement earnings, is about right for the long run; Social Security benefits are currently much lower than generally believed and, contrary to the popular wisdom, the role of private pension plans or IRAs is not going to increase substantially in the future.

The exaggerated view of Social Security comes primarily from the replacement rates for hypothetical workers that are published regularly by the Social Security Administration. These figures show the average employee receiving retirement benefits equal to 41 percent of previous earnings. If the retiree has a spouse eligible for dependent's benefits, the couple's

benefits rise to 62 percent of their preretirement earnings. Since retirees need roughly 70 percent of preretirement earnings to maintain their standard of living, it appears that Social Security is doing almost the entire job.

These figures exaggerate Social Security's role for three reasons. First, most people retire before age 65 and therefore have their benefits actuarially reduced; the replacement rate for the hypothetical average worker at age 62 is 34 percent rather than 41 percent. Second, only 27 percent of retirees have spouses eligible for the full 50 percent supplementary benefit. Hence, calculating the typical couple's benefit as 150 percent of the primary amount overstates the level of Social Security replacement. Finally, the average person about to retire is earning more than the average for all workers in all stages of their careers and therefore under a progressive benefit formula has a lower replacement rate.

The average monthly benefit for a retired worker in January 1988 was \$513, or \$6,156 per year. Replacement rates are roughly 33 percent for retirees in the middle of the income distribution and 40 percent for couples similarly situated. These are not excessively generous provisions. Moreover, if the scheduled extension in the retirement age goes into effect beginning in 2003 and retirement patterns do not change very much, as is anticipated, retirement benefits will be further discounted for those who retire before age 67. In other words, for most people a reduction in benefits is already scheduled after the turn of the century.

The fundamental problem with increased reliance on the private pension system or IRAs is that not everyone has or will have this form of protection. Only about half the workforce participates in a pension plan and coverage tends to be concentrated among the higher paid. Moreover, because of the influence of industry structure on pension coverage, the percentage of the workforce covered is not expected to increase significantly in the future. In

fact, the most recent surveys show that after decades of expansion, pension coverage declined noticeably between 1979 and 1986. Coverage for wage and salary workers fell from 56 percent in 1979 to 52 percent in 1986.

Attempts to broaden participation in pension arrangements through IRAs have not been very successful. Even though IRAs were designed for those without pension coverage, it soon became evident that these accounts were being used disproportionately by higher-income people, many of whom already had pension coverage.

Hence, with our current institutional arrangements, it does not seem sensible to reduce the role for Social Security.

3. While Sweden, Canada and Japan have all attempted to augment private savings by building large public pension trust fund reserves, only Sweden has been successful. The partial funding of the Swedish National Pension Insurance Fund was an attempt to offset an extremely low private savings rate and the program appears to have been fairly successful; from its inception through 1977, large annual surpluses swamped deficits in the general accounts. While a weak economy led to overall negative numbers from 1978 to 1986, Sweden is once again experiencing overall budget surpluses and projections indicate that it will continue doing so. By 1986 pension reserves equalled approximately 31 percent of GDP and accounted for more than one-third of the stock in the organized credit markets. To avoid disrupting financial markets, Sweden developed three different funds which compete with each other for debt issues. Nearly half of the issues held by the funds come from housing credit institutions. Recently, Sweden liberalized the investment policies of these funds by directing them to pursue the highest low-risk return possible. Additionally, a fourth, somewhat controversial fund was instituted in 1974. This fund invests in corporate stocks, thereby augmenting the availability of capital in the private equity markets.

Japan's Employees' Pension Insurance Fund held assets equal to about 17 percent of GDP assets in 1986. Unlike Sweden, however, Japan's public pension surpluses have been unable to offset the large deficits run in the general accounts. In fact, easy access of the central government to the pension reserves may have promoted a more expansive fiscal policy than would have otherwise been undertaken. Japan's funds are invested entirely in government and quasi-government issues. Investments emphasize housing and agencies that service insured persons and their dependants.

Finally, the Canada Pension Plan, which in 1987 held assets equal to 6 percent of GDP, was originally proposed as a pay-as-you-go program, but provincial governments insisted that the system be substantially funded and the annual surpluses made available to the provinces for use as investment capital. Unfortunately, provinces have simply increased their borrowing demands in response to the growth in the amount of funds available. Consequently, pension surpluses have been unable to offset deficits in the general accounts. Canada offers all its reserves to the provinces, often at below-market rates. Any excess reserves are invested in central government issues.

Despite the mixed record of success, a more detailed look at the foreign experience would probably be quite useful if the U.S. decides to continue accumulating large trust fund surpluses.

Questions for Alicia Munnel from Rep. Crane

1. Would the social security program and perhaps the economy as a whole be more stable if we repealed the accelerated tax schedule for 1990, and let the payroll tax revert to a pay-as-you-go basis?
2. If we were to enact legislation along the lines Mr. Myers is proposing, would it be prudent to cushion out or spread out the peak tax years? If so, what upper limits for FICA/SECA would you recommend?
3. Is it possible, as some economists speculate, that mounting surpluses will reduce purchasing power and choke off economic growth?

Responses to questions from Rep. Crane:

1. The Social Security tax increase scheduled for 1990 should not be repealed. The additional revenue is needed for two reasons. The first is to accelerate the process of accumulating an adequate contingency reserve. In order to avoid the serious financial crises experienced in the late 1970s and early 1980s, the contingency fund should equal roughly 150 percent of annual outlays. At present, assets equal only 41 percent of outlays and are not scheduled to reach the 150 percent mark until 1995. Repealing the 1990 increase would only prolong this process and subject the system to unnecessary risk.

The second reason for maintaining the 1990 increase is that it is an integral part of the long-term financing arrangement. Repealing this tax will force the system out of long-run actuarial balance and require a substitute tax increase at some other point in time.

2. If the Congress were to adopt Mr. Myers' recommendation to return to pay-as-you-go financing, thereby delaying the build-up of a contingency fund and ignoring the future financing requirements of Medicare, then the rate structure presented in his testimony seems as good as any. However, given the need to accumulate an adequate contingency reserve as soon as possible and the fact that Medicare costs will make large demands on future payroll tax revenues, it is probably unwise to reduce taxes at all for the next several years. If in the mid-1990s, a return to current cost financing is preferred, tax rates can be adjusted at that time.

3. Higher saving, either through the accumulation of government surpluses or the activity of private individuals, need not reduce purchasing power nor choke off economic growth provided two conditions are met. The first is that the rate of change be slow enough for the economy to adjust. For example, efforts to eliminate the entire budget deficit in one year would probably have adverse economic implications, but gradually reducing the deficit and moving into surplus, say, over a five-year span would be manageable. The second condition is that monetary policy during the period of increasing saving be expansionary enough to keep the economy at full employment. In short, while care must be taken, fear that mounting surpluses will choke off economic growth should not be given much weight.

ANDY JACOBS, JR., INDIANA, CHAIRMAN
SUBCOMMITTEE ON SOCIAL SECURITY

RICHARD A. GEPHARDT, MISSOURI
SAM M. GIBBONS, FLORIDA
SANDER M. LEVIN, MICHIGAN
JIM MOODY, WISCONSIN

BILL ARCHER, TEXAS
PHILIP M. CRANE, ILLINOIS
HAL DAUER, NEBRASKA

Ex Officio:
DAN ROSTENKOWSKI, ILLINOIS
JOHN J. DUNICAN, TENNESSEE

DAN ROSTENKOWSKI, ILLINOIS, CHAIRMAN
COMMITTEE ON WAYS AND MEANS

ROBERT J. LEONARD, CHIEF COUNSEL
M. KENNETH BOWLER, STAFF DIRECTOR
SANDRA CASPER WISE, SUBCOMMITTEE STAFF DIRECTOR

A.J. BRISLATOR, MINORITY CHIEF OF STAFF
KAREN R. WORTH, SUBCOMMITTEE MINORITY

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515
SUBCOMMITTEE ON SOCIAL SECURITY

May 18, 1988

Mr. Henry Aaron
The Brookings Institution
1775 Massachusetts Avenue N.W.
Washington, D.C. 20036

Dear Mr. Aaron:

I very much appreciate your contribution to our hearing on May 10th regarding the social security trust fund reserves.

Attached are several questions from Members of the Subcommittee who were unable to attend the full hearing. They would appreciate your expert opinion on these questions for inclusion in the official hearing record.

I would appreciate it if you could provide the Subcommittee with a response by May 27, 1988.

Sincerely,

Andy Jacobs, Jr.
Chairman

AJ/wd

Enclosures

Questions for Henry J. Aaron from Rep. Archer

1. If we were to consider Mr. Myer's alternative financing, how do you think today's workers, many of whom are in the baby boom generation, would perceive a return to pay-as-you-go financing? Would they appreciate the tax cut, or worry more that Congress is again tampering with the system?
2. Some 60 years down the road the system will be exhausted. There are alternatives to increasing payroll taxes--for example increasing the reduction or phasing up the age for early retirement, or placing greater reliance on IRA's. Do you think we should encourage tomorrow's workers to rely a little less on social security in their retirement planning? If you concur, what alternatives would you advocate and why?
3. In terms of interest rates and the reliance many investors place on Treasury securities, what are the implications of the social security trust funds absorbing "external debt"?
4. If, as most of you seem to agree, projected surpluses shouldn't be used as an alternative to financing other federal expenditures, and we should actually achieve a balanced budget, where should social security trust funds be invested?
5. Assuming we should diversify investments, should we invest in other government backed securities--like home mortgages--the private sector, state and local government, or indeed foreign investments?
6. In order to minimize the impact on the need for federal taxes to pay benefits, when should this diversification begin?

The Brookings Institution



1775 MASSACHUSETTS AVENUE N.W. / WASHINGTON D.C. 20036-2188 / CABLES: BROOKINST / TELEPHONE (202) 797-6000

Economic Studies Program

May 26, 1988

The Honorable Bill Archer
Committee on Ways and Means
U. S. House of Representatives
Washington, D.C. 20515

Dear Congressman Archer:

This letter contains my responses to the six questions that you conveyed to me through committee staff after my testimony.

1. Mr. Myers' proposal amounts to a close approximation to pay-as-you-go financing of social security. Taxes could certainly be set approximately to equal outgo each year. From the standpoint of an actuary, such a tax schedule could be made fully adequate to cover projected outlays.

I do not claim expertise on how public confidence would be affected by alternative tax schedules. This is not an area of expertise that emerges from training in economics—or, for that matter, actuarial science. However, I strongly suspect that public confidence in the reliability of commitments to pay social security benefits in the future, especially a future in which costs will rise, will be far stronger if those promises are backed by a large trust fund than if they are not.

The chief argument for a trust fund, in my view, is not its possible effect on public sentiment, but rather the potential economic benefits that it can generate. The United States badly needs to increase its national saving rate. For any given level of private saving and of government saving on activities other than social security, national saving will be increased dollar-for-dollar by increases in social security reserves. The key to these benefits is that social security reserves not lead to increased deficits elsewhere in the federal budget.

Against this background, I view as particularly unfortunate the policy expressed in the Gramm-Rudman-Hollings deficit reduction targets of treating social security surpluses as offsets against even larger deficits elsewhere in the federal budget. We should aim for approximate balance in the non-social-security budget, a goal which, if achieved, would increase national saving by about 5 percent of net national product.

2. I disagree with the premise of the question. As I indicated in my testimony, social security reserves will not be depleted if we adhere—as I think we should—to the requirement that projected revenues must remain sufficient to cover projected benefits, each measured over the next seventy-five years. This observation seems to conflict with the projections of actuarial balance published this year, which indicate the depletion of trust funds after about 2035.

Within a few years, however, new seventy-five year projections will indicate that the social security system has moved out of long-term balance. This loss of balance will occur because each new forecast eliminates one early year (for example, the 1989 projections will eliminate 1988) and incorporate a new terminal year (for example, the terminal year of the 1989 projection will be 2063, while the terminal year for the 1988 projections is 2062). Since the early years are surplus years, and the later years are deficit years, the seventy-five year projections tend each year to move toward deficit.

When the deficit reaches 5 percent of projected outlays, the system moves out of close actuarial balance. When it does so, Congress has customarily either reduced benefits or raised taxes by enough to restore approximate balance. Such legislative changes tend to increase the amounts by which the trust fund balances grow or to reduce the amounts by which they fall.

At the Brookings Institution we have computed the effects of such changes. We find that if Congress keeps social security within close actuarial balance, the trust fund will not decline, but in fact will continue to grow.

This development is wholly salutary, as it means that social security can continue to add to national saving into the indefinite future.

Looking ahead, I think that the prudent course in planning for retirement income is for individuals to base their private saving decisions on the assumption that social security will exist in a form very much like its current form. That means that it will provide adequate income replacement for workers with below-average earnings, but that all other workers should make arrangements for additional sources of retirement income. Such sources could include private company pensions, individual tax-sheltered saving, or ordinary saving.

3., 4., 5., and 6. I support continuation of current policies for investing social security reserves in Treasury debt. The amount of such debt will exceed reserves for decades. If, through some miracle of political statesmanship, we succeed in eliminating the federal deficit, then simple adherence to current law will eventually result in social security reserves larger than the currently outstanding federal debt.

Some part of social security reserves could then be invested in federal agency debt with no change in law.

Direct investment of social security reserves in private assets is inadvisable, in my view, as it would raise vexing issues of federal involvement in investment decisions in which the federal government has no proper place. Furthermore, it would expose the social security trust funds to risks of default and price fluctuations that they do not and should not face.

The yields on investments in Treasury securities are somewhat below yields on federal agency debt and considerably below yields on private securities of corresponding maturities. In the case of agency debt, it is hard to see what risk considerations cause the higher yields; accordingly, a policy of investing some portion of social security reserves in such assets has considerable appeal. The higher yields on private securities are associated with significantly increased risks, which I do not think that the social security system should face.

It is important to understand that even if social security could earn an increased yield by investing in financial assets other than Treasury debt, the real economic burden of social security on the economy would not be affected by such a change in investment policy unless it led to changes in real investments that increased overall productivity. There is no reason to expect that if social security reserves were invested differently any such change in the composition of real investments would occur.

I hope that these replies are responsive to the questions that you posed. If I can be of further assistance, I should be pleased to respond in any way that I can.

Sincerely yours,



Henry J. Aaron
Senior Fellow

Questions for Henry J. Aaron from Rep. Crane

1. Would the social security program and perhaps the economy as a whole be more stable if we repealed the accelerated tax schedule for 1990, and let the payroll tax revert to a pay-as-you-go basis?
2. If we were to enact legislation along the lines Mr. Myers is proposing, would it be prudent to cushion out or spread out the peak tax years? If so, what upper limits for FICA/SECA would you recommend?
3. Is it possible, as some economists speculate, that mounting surpluses will reduce purchasing power and choke off economic growth?

The Brookings Institution



1775 MASSACHUSETTS AVENUE N.W. / WASHINGTON D.C. 20036-2188 / CABLES: BROOKINST / TELEPHONE: (302) 797-6000

Economic Studies Program

May 26, 1988

The Honorable Philip Crane
Committee on Ways and Means
U. S. House of Representatives
Washington, DC 20515

Dear Congressman Crane:

This letter is my response to the written questions that you had transmitted to me following my testimony before the Committee on Ways and Means.

1. Any policy that reduced taxes without corresponding decreases in public spending would add to the federal deficit and further reduce the already disturbingly low U.S. national saving rate. Your question made no mention of reducing social security benefit payments in 1990 to offset the reduction in taxes from currently scheduled rates. While I would oppose such cuts for other reasons, I think it would be fiscally irresponsible to reduce scheduled taxes unilaterally.

According to projections of the Congressional Budget Office, the federal deficit on operations of government other than social security is actually rising not falling. The only reason why the overall deficit is projected to fall is the prospect of the surpluses that the 1990 rate increases do much to generate.

Because of the lack of U.S. saving, we are now borrowing huge amounts abroad leading to distressing foreign trade deficits. Any decision to put off the payroll tax increases in 1990 would increase the amount we must borrow abroad and the size of the trade deficits we face. I can think of few actions more detrimental to the long-term economic health of the United States than actions that would increase the size of the federal deficit and the amount of borrowing from abroad.

2. Mr. Myers proposes no reduction in social security benefits. He is merely proposing a different schedule of taxes to pay for currently promised benefits. If we don't collect the taxes now, we shall have to collect them later. Following the logic of his approach, the only upper limit on taxes is the amount necessary to cover the cost of benefits promised under current law.

One can't have it both ways. If social security taxes are reduced now, they will have to be increased enough later to cover the cost of benefits. One of the appeals of building up a reserve now through higher taxes than are necessary to pay for current benefits is that doing so permits future tax rates to be kept lower than would otherwise be necessary.

3. The surpluses called for in the social security system grow so gradually that they pose no meaningful problem for management of economic policy.

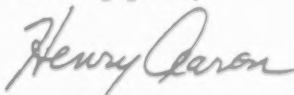
Between the 1970s and the 1980s the U.S. national saving rate dropped from about 8 percent of net national product to about 2 percent. To the best of my knowledge, every economist of whatever political persuasion holds that the saving rate should be increased and that it can be restored to at least the level of the 1970s over a period of five to ten years. Thus, increasing saving by 6 percent of net national product over a period of—at most—ten years is considered highly desirable.

This target contrasts with an increase in the social security surplus from current levels of about 0.5 percent of net national product to a maximum of about 2 percent of net national product (under current projections) about thirty years from now.

This comparison indicates that there is no basis whatsoever for the suggestion that the accumulation of social security surpluses is incompatible with high employment. Because it would represent an addition to national saving, it will tend to promote economic growth.

I hope that these responses to your questions are helpful. If I can be of any further assistance, I should be glad to respond in any way that I can.

Sincerely yours,



Henry J. Aaron
Senior Fellow

ANDY JACOBS, JR., CHAIRMAN
SUBCOMMITTEE ON SOCIAL SECURITY

EDWARD A. COFFMAN, JR., CHAIRMAN
SUBCOMMITTEE ON SOCIAL SECURITY
SUBCOMMITTEE ON SOCIAL SECURITY
AND SOCIAL SECURITY

DR. ARTHUR, TEXAS
RICHARD H. COOK, CHAIRMAN
RICHARD H. COOK, CHAIRMAN

DR. ARTHUR
DR. ARTHUR, TEXAS
DR. ARTHUR, TEXAS

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, DC 20515

SUBCOMMITTEE ON SOCIAL SECURITY

DAN ROSTENOWSKI, CHAIRMAN
COMMITTEE ON WAYS AND MEANS

ROBERT J. COOPER, STAFF DIRECTOR
DR. COOPER, STAFF DIRECTOR
GABRIEL COOPER, STAFF DIRECTOR

A. J. COOPER, STAFF DIRECTOR
A. J. COOPER, STAFF DIRECTOR

May 18, 1988

Mr. John L. Palmer
Senior Fellow
Urban Institute
2100 M Street N.W.
Washington, D.C. 20037

Dear Mr. Palmer:

I very much appreciate your contribution to our hearing on May 10th regarding the social security trust fund reserves.

Attached are several questions from Members of the Subcommittee who were unable to attend the full hearing. They would appreciate your expert opinion on these questions for inclusion in the official hearing record.

I would appreciate it if you could provide the Subcommittee with a response by May 27, 1988. If your European trip prevents you from meeting this deadline for the printed record, we will retain your response in the unprinted official file of the hearing.

Sincerely,

Andy Jacobs, Jr.
Chairman

AJ/wd

Enclosures

June 14, 1988

Answers to Representative Archer's Questions

1. If we were to consider Mr. Myer's alternative financing, how do you think today's workers, many of whom are in the baby boom generation, would perceive a return to pay-as-you-go financing? Would they appreciate the tax cut, or worry more that Congress is again tampering with the system?

Answer. I believe today's workers would worry more that Congress is again tampering with the system and lose their already tenuous confidence that the solvency of the system during their retirement is assured.

2. Some 60 years down the road the system will be exhausted. There are alternatives to increasing payroll taxes--for example increasing the reduction or phasing up the age for early retirement, or placing greater reliance on IRA's. Do you think we should encourage tomorrow's workers to rely a little less on Social security in their retirement planning? If you concur, what alternatives would you advocate and why?

Answer. Yes I do think that we should encourage tomorrow's workers to rely a little less on Social Security in their retirement planning, particularly those of higher income. I would favor phasing in fuller taxation of Social Security benefits in the short run and eventually an additional increase in the normal age of retirement in the long run as ways of helping to deal with the shortfall problem beginning mid next century.

3. In terms of interest rates and reliance many investors place on Treasury securities, what are the implications of the Social Security trust funds absorbing "external debt"?

Answer. I believe the partial absorption of "external debt" by the Social Security trust funds is a favorable phenomenon. It is not likely to be of such a magnitude to cause any great problems and will help to hold down overall interest rates by increasing the level of domestic savings.

4. If, as most of you seem to agree, projected surpluses shouldn't be used as an alternative to financing other federal expenditures, and we should actually achieve a balanced budget, where should Social Security trust funds be invested?

Answer. As long as the total of the trust fund surpluses doesn't threaten to approach 100 percent of the total national debt, I believe the funds should continue to be invested in Treasury bills as presently. If it appears that they will approach 100 percent then some diversification into other quasi public governmental guaranteed debt instruments such as those issued by federal housing mortgage authorities would be advisable.

5. Assuming we should diversify investments, should we invest in other government backed securities--like home mortgages--the private sector, state and local government, or indeed foreign investments?

Answer. We should stick to other federally-backed securities in order to preserve workers' confidence in the Social Security system and avoid issues surrounding the government having to select a private portfolio.

6. In order to minimize the impact on the need for federal taxes to pay benefits, when should this diversification begin?

Answer. Only if and when trust fund holdings of Treasury bills begin to absorb the large majority of federal debt.

June 14, 1988

Answers to Representative Crane's Questions to John Palmer

1. Would the Social Security program and perhaps the economy as a whole be more stable if we repealed the accelerated tax schedule for 1990, and let the payroll tax revert to a pay-as-you-go basis?

Answer. No. I do not believe the scheduled payroll tax for Social Security poses any appreciable problem for general economic stability, and its repeal (unless compensated for by an equivalent increase in revenues to the program from another source or reduction in future benefit commitments) would greatly add to the loss in confidence about the future solvency of the program during the retirement of the baby boom that is already a concern among today's younger workers.

2. If we were to enact legislation along the lines Mr. Myers is proposing, would it be prudent to cushion out or spread out the peak tax years? If so, what upper limits for FICA/SECA would you recommend?

Answer. I believe that Mr. Myer's proposal should not be enacted.

3. Is it possible, as some economists speculate, that mounting surpluses will reduce purchasing power and choke off economic growth?

Answer. No more so than an appreciable increase in the national savings rate achieved through alternative means. Such an increase is badly needed for long-term capital formation and economic growth and need not pose a problem for shorter term economic stability if overall fiscal and monetary policies are appropriately coordinated. In short, having to deal with an increase in the rate of public savings (or decrease in the large current dissavings) is a problem I would love to have.

[Submissions for the record follow:]

STATEMENT OF THE COMMITTEE ON SOCIAL INSURANCE
OF THE
AMERICAN ACADEMY OF ACTUARIES
REGARDING THE
1988 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE
AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS

MAY 24, 1988

The American Academy of Actuaries is a professional association of somewhat over 8,800 actuaries involved in all areas of specialization within the actuarial profession. As a national organization of actuaries, the Academy is unique in that its members have expertise in all areas of actuarial specialization. Issues relating to the financing of Social Security are part of the responsibility of the Academy's Committee on Social Insurance.

The committee has reviewed the 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (OASDI). The committee has not considered the validity and nature of the many demographic assumptions in order to derive the actuarial estimates. The committee does, however, wish to comment on a specific recommendation contained in the report. Because the program is entering a period of large fund accumulation, the Board of Trustees recommends that the proper level of fund accumulation should be made a part of the agenda for the next Advisory Council on Social Security. The Board also suggests that a panel of financing experts (consisting of actuaries, economists, and demographers) be appointed by the Advisory Council, and "that the panel be instructed to provide advice regarding the measures that should be used to judge the program's short-range and long-range financial soundness." The Committee on Social Insurance strongly supports this recommendation and hopes that such a panel would also be consulted with regard to the Medicare program. We would be happy to lend our expertise to such a panel.

In connection with this, we would also reiterate our previous recommendation that, in the interest both of developing more public confidence in the system and of assuring the continued integrity of the actuarial estimates, an independent board of actuaries should be appointed to conduct a continuing review of the methodology underlying the actuarial estimates for the Social Security and Medicare systems, as well as the measures of actuarial status used. This procedure would be similar to that currently being followed by the Civil Service Retirement System, the Military Retirement System, and the Railroad Retirement System.

Committee on Social Insurance

Robert J. Myers, Chairperson
John I. Mange
Roland E. King
James L. Cowen
Dwight K. Bartlett, III
Joseph L. Petrelli
Sam Gutterman
Francisco R. Bayo
Bruce D. Schobel
Warren R. Luckner
Toni S. Hustead
James M. Berry

STATEMENT OF THE HONORABLE PHIL CRANE

MR. CHAIRMAN, I APPRECIATE YOUR SCHEDULING TODAY'S HEARING. AS A NEW GRANDFATHER I AM VERY MUCH INTERESTED IN THE LONG-TERM HEALTH OF THE SOCIAL SECURITY SYSTEM.

I ADMIT TO SOME SKEPTICISM WHEN I LISTEN TO PROJECTIONS OF A BUILD UP OF SOCIAL SECURITY TRUST FUNDS -- THE OLD AGE AND SURVIVOR AND DISABILITY FUNDS -- TO A LEVEL WHICH EXCEEDS 28% OF GNP IN 2019. I STILL REMEMBER PRESIDENT CARTER ASSURING US IN 1977 THAT SOCIAL SECURITY WAS FINANCIALLY SOUND FOR THE NEXT 50 YEARS. WE ALL REMEMBER WHAT A SHORT-TERM ECONOMIC DOWN-TURN DID TO THOSE OPTIMISTIC PROJECTIONS.

SO, MY FIRST QUESTION FOR TODAY'S WITNESSES IS THIS: JUST HOW CONFIDENT ARE YOU ABOUT THE TRUST FUND PROJECTIONS AS REPORTED BY THE BOARD OF TRUSTEES?

THEN, ASSUMING THE TRUST FUNDS WOULD -- UNDER CURRENT LAW -- ACCUMULATE TO A LEVEL EXCEEDING 5 YEARS OF BENEFITS IN 2015, ACCORDING TO THE 1988 TRUSTEES REPORT, MY SECOND QUESTION IS: IS THAT LEVEL OF ACCUMULATION DESIRABLE?

I'M PLEASED THAT FORMER CHIEF ACTUARY ROBERT MYERS IS WITH US TODAY, BECAUSE I KNOW THAT HE HAS RESERVATIONS ABOUT BUILDING UP THAT MOUNTAIN OF RESERVES OVER THE NEXT 30 YEARS, THEN DESCENDING INTO BANKRUPTCY BY 2048. I WANT TO HEAR BOTH SIDES OF THIS ISSUE DEVELOPED TODAY, BECAUSE IT MAY BE ONE OF THE MOST IMPORTANT DECISIONS WE MAKE, NOT ONLY FOR THE SOCIAL SECURITY PROGRAMS, BUT FOR THE ECONOMIC HEALTH OF OUR COUNTRY.

STATEMENT FOR THE RECORD BY CONGRESSMAN BYRON L. DORGAN
NORTH DAKOTA
SUBCOMMITTEE ON SOCIAL SECURITY
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
MAY 10, 1988

I would like to express my concern about the inclusion of the Social Security trust funds in the Gramm-Rudman deficit calculations. This process of using Social Security surpluses as offsets to operating budget deficits masks the real extent of the budget crisis and will result in enormous fiscal problems in the future.

This fiscal year, the Social Security Trust Fund accounts will accumulate a surplus of almost of \$40 billion. These receipts are loaned to the U.S. Government to fund operating programs and are also counted in the deficit calculations as an offset to other expenditures.

The inclusion of the Social Security trust fund in the deficit calculations causes the federal deficit to appear almost \$40 billion smaller than it actually is. Not only is this dishonest budgeting, but it will cause a serious problem in 1993, when the trust fund will no longer be included in the deficit calculations. By that time the trust fund balance will be almost \$100 billion and we will be forced to scramble to find this much additional revenue to offset its removal from the deficit calculations.

As members of Congress, it our role to assure that the trust and faith our constituents have that the funds they are setting aside for their future retirement will indeed be there when needed, is not blind. The dedicated taxes paid by our constituents for the purpose of financing their future retirement claims should be set aside, as promised, with the assurance that these funds will be available when needed.

Sound planning must take place now to protect the integrity of our Social Security Trust Fund. We must implement budgeting procedures that give a true and accurate reflection of our operating expenditures.

For this reason, Congresswoman Mary Rose Oakar and I have introduced "The Truth in Social Security Accounting Act of 1988". This legislation calls for the removal of the Social Security Trust Fund from the deficit calculations as of September 30, 1989. We have also formed an ad hoc task force comprised of high-level experts who will formulate a series of recommendations on how to implement this bill.

We must act promptly and effectively to ensure workers and retirees will be able to count on a sound Social Security pension and disability program. We must protect the integrity of the Social Security Trust Fund and prevent its continuing use as a slush fund for other spending.

JRC

Lafayette G. Eads
 NCPSSM Grassroots Division
 410 E. Southern Dr.
 Bloomington, IN 47401 (Phone: (812-339-1290)
 May 14, 1988

Written comments for the printed record of the Hearing on Social Security Trust Fund Reserves, held on May 10, 1988, by the Social Security Subcommittee.

Mr. Chairman:

Being involved in the fight to get the Notch Inequity corrected and having testified at the hearing on the notch on April 14, 1988, which you also chaired, I feel that I am qualified to comment on this subject.

First of all, I would submit that we "Notch Victims" have been victimized to pay for the mistake of congress in 1972 when they created a huge bonanza for social security recipients born between 1912 and 1916. Now that we have been victimized and made the scapegoats for this mistake, we are now being victimized again by building up the funds for the "baby boomers". And now you are holding a hearing on what to do with our money!

Mr. Chairman, the answer is as clear as the nose on your face. Put the Social Security Trust Fund clear of the Federal Budget balancing process, clear of the Federal Deficit and the Graham-Rudman Act. The last two Social Security Tax increases should not be implemented and the Social Security Trust Fund Payments should be put back on a pay as you go system, which worked so well for many years. In 1972, Mr. Chairman, you broke it and now you can not fix it. You have all forgotten your basics and grassroots. You have complicated Social Security so much that a simple "fix" eludes you. Back to "basics" is the answer and correct your mistakes along the way.

The Social Security Trust Fund is predicted to be over 11 trillion dollars by the year 2029. Having this huge fund around will be very tempting to future manipulators of the Federal Government, in fact, Mr. Chairman, we the "Notch Victims" feel that such huge reserve is not necessary and even with a notch correction, the last two taxes for Social Security should not be implemented, they are absolutely not needed to bolster a fund that will reach such huge proportions as it is.

Let me remind you Mr. Chairman that the Social Security as created by the great Franklin Delano Roosevelt, was not intended for make shift cover-up for government short-comings and there are plenty of them. Let us not tempt your successors, lest they fall into the same trap you now find yourself in.

Mr. Chairman, I feel that it is my duty to inform you of a growing movement in the great state of Indiana to abort your re-election this fall. Your leftist-liberal abandonment of the Nicaraguan Freedom Fighters and the failure to let legislation on the floor of the House of Representatives, that should be up for debate in the legislature and not controlled by one so prejudiced as yourself. We feel that your arrogance will not let you solve the Social Security Trust Fund Problem.

Mr. Chairman, there are over 38 million people out here depending on you and your committee to do the right thing to protect social security for them and not be mishandled by the government as in the past.

Mr. Chairman, let me say that I highly respect the office you hold, but that is all.

Lafayette G. Eads
 Lafayette G. Eads

Testimony From Mr. Edwin K. Miner - Hoosier Coordinator
The Committee to Correct Inequities in Social Security and Medicare, Inc.
Council Bluffs, Iowa

Report to: the Chairman, Subcommittee on Social Security,
Committee on Ways and Means, House of Representatives
May 3, 1968

May 1968

SOCIAL SECURITY TRUST FUND RESERVES AND
THE FINANCING OF RETIREMENT BENEFITS FOR
THE "BABY-BOOM" GENERATION.

I INTRODUCTION

According to SSA Publication No. 05-10377 issued March 1968, the Social Security program continues to operate on a sound financial basis. Income is expected to exceed outgo by about \$36 billion this year. Current estimates show that the program will be able to pay benefits into the next century. Their table shows that in the year 2000 the income will exceed outgo by \$0.4 billion and the amount in the Trust Funds is estimated at \$1.3 trillion.

II PROBLEMS ATTENDANT UPON SOCIAL SECURITY SURPLUSES

These "surplus" Social Security funds are not used only for Social Security purposes; but they are invested, by law, in interest-bearing government securities. In effect the funds are used to decrease how much the federal government would have to borrow from domestic or foreign investors. A recent study entitled "Retirement Income for an Aging Population" states, "the projected annual Social Security surpluses are so great that the federal external debt - assuming that general fund deficits cease from the mid-1990s on - probably could be brought completely within the Social Security Trust funds by 2010."

To the extent that happens, then the huge Social Security surpluses may actually compound the deficit tax problems of the next generation, while giving us a false sense of security, since the Social Security account will show huge reserves that in reality have already been spent to hide the size of the deficits in other programs.

In either case, the large and growing annual Social Security surpluses will shift the burden of paying today's government programs from the income tax and other revenue sources to the Social Security tax.

Someday, when Social Security needs to call in its loans to pay benefits to the Baby Boomers, income and other general revenue taxes will need to be raised. So, at the very least, we should ask ourselves whether it makes sense to use Social Security taxes to pay the general government's bills in this century and then to use the general government's revenues to pay Social Security's bills in the next century.

III CURRENT-COST FUNDING RECOMMENDED FOR OASDI

In analyzing the long-term condition of Social Security, GAO in its recent report accepted the conventional wisdom that traditional current cost financing should be abandoned and surpluses accumulate to help pay the retirement benefits of the baby boom generation. Numerous policy analysts, however, are challenging this conventional wisdom, including former Social Security actuary Robert Myers. Myers, frequently cited in the GAO report, recently said that these increases were unnecessary (Robert J. Myers, "Social Security Roller Coaster," Washington Post, August 20, 1967). Testifying at the Senate hearing, he said that current-cost funding is generally preferred over advance funding. The present system, a variety of advance funding, suffers in his view from the temptation it offers for excessive government spending. Accordingly, he would prefer that financing be on a "close to current-cost basis," with income slightly exceeding outgo each year, the intention being to build up a fund that is about equal to one years' outgo, and no more than that.

This proposal is based on intermediate-cost assumption about future performance of the economy. Future Congresses could legislate changes, if necessary, or an automatic adjustment mechanism could be established in the law.

IV WHAT SHOULD BE DONE TO PRESERVE THE SOCIAL SECURITY TRUST FUNDS

Remove Social Security Trust Fund operations completely from the Budget process including all calculations of the annual deficit reduction targets.

Restore benefit equity to the Social Security program by correcting the unintended rapid reduction in benefits for persons born after 1916. Notch reduction averages in the five year transition are more than double congressional intent. (1977 Social Security Amendments)

Maintain the solvency of the Social Security Trust Funds on a sound, pay-as-you-go basis by reducing future payroll tax rates to the lowest possible level consistent with the maintenance of a healthy Trust Fund Reserve and the payment of full and fair benefits to current and future retirees.

Assure the administrative integrity of the Social Security Administration by restoring Social Security to its original status as an independent government agency governed by its own Board of Directors appointed by the President and confirmed by the Senate.

Workers pay Social Security taxes to earn a right to a Social Security benefit, and their Social Security contributions should be managed and used for the sole and exclusive purpose for which they were raised. If we have a deficit problem in the rest of government, than we should solve it and not hide behind Social Security surpluses.

